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OF
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Bills Committee on Inland Revenue (Amendment) (No.4) Bill 2015
Legislative Council Secretariat
1 Legislative Council Road
Central
Hong Kong

Comments on the Inland Revenue (Amendment) (No.4) Bill 2015 on the Tax Treatment of Regulatory Capital Securities under the Basel III Framework

Dear Sir / Madam

We refer to the Inland Revenue (Amendment) (No.4) Bill ("Bill") with respect to the Tax Treatment of Regulatory Capital Securities ("RCSs") under the Basel III Framework as implemented in Hong Kong under the subsidiary legislation of Banking (Capital) Rules (Cap. 155L) ("BCR") under the Banking Ordinance (Cap. 155), to be introduced into the Inland Revenue Ordinance (Cap. 112) ("IRO") and the Stamp Duty Ordinance (Cap. 117) and we enclose our submission on the Bill ("Enclosed Submission").

HKAB appreciates the Government's efforts in introducing the Bill, which has been well received by the industry as it generally aligns the key objectives of the industry in achieving certainty on tax treatment in respect of RCSs as follows:

- These financial instruments should be treated as debt instruments so that the coupons are regarded as interest for determining the deductibility of coupon payments to the issuing banks, and taxability of the same in the hands of the investors.

- Any gains or conversions or write down of the principal amount shall be exempt from Hong Kong profits tax.

- The transfer or sale and purchase of these instruments shall be exempt from Hong Kong stamp duty.

This is essential as to maintain a level playing field for financial institutions ("FIs") in Hong Kong vis-à-vis their peers in the other international financial centers such as London and Singapore which have already put in place specific tax provisions catering for RCSs.

While the Bill has been largely welcomed by the industry, we have received from our members further comments in respect of the Bill which require further consideration by the Government to ensure proper application of the legislation to *bona fide* regulatory capital security transactions as well as to avoid any potential conflict to the current territorial source taxation regime enshrined in the IRO. Below is HKAB's summary of the industry's specific concerns on the provisions of the Bill:

- The current definition of "security" (Section 17A) in the Bill may exclude certain Basel III compliant Additional Tier 1 ("AT1") and Tier 2 ("T2") instruments which have been issued for bona fide regulatory reasons from qualifying as RCSs for the purposes of the Bill. We request Section 17A to be amended or clarified such that all the Basel III regulatory compliant AT1 and T2 non-share instruments qualify as RCSs for the purposes of the Bill.

- Section 17F as currently drafted may result in full disallowance of interest deduction where RCSs are indirectly funded by externally issued RCSs by a FI's overseas group holding company which are largely issued to the public with a very small portion held by specified connected persons for bona fide commercial purpose (e.g. acting as underwriter in case of under subscription by the market). While we appreciate the policy intent, these provisions are highly restrictive and we therefore request Section 17F to be amended to allow proportional deduction of interest "to the extent" that the RCSs are directly or indirectly funded by externally issued RCS and not held for the benefits of the specified connected persons. The practical application of these tests and the calculation mechanism should also be clarified in Departmental Interpretation and Practice Note ("DIPN") intended to be issued by the Inland Revenue Department ("IRD") to remove uncertainty.

- The industry is of the view that introduction of the proposed Section 17G and Section 17H in the Bill to codify the Organisation for Economic Co-operation and Development's ("OECD") profits attribution approach to permanent establishment into Hong Kong's tax legislation is a significant change and a move away from the sourced based principles of taxation enshrined in the current tax legislation and will result in inconsistent treatment between Hong Kong incorporated taxpayers and non-resident taxpayers in ascertaining chargeable profits in Hong Kong. We request that these two provisions be removed from the Bill and be introduced only after careful deliberation and comprehensive consultation with the industry and impacted parties.

- It is common for banks to hedge their financial risks (e.g. interest rate and exchange rate risks) with respect to the RCSs. The Bill suggests that in ascertaining the profits of the issuer of the RCSs with respect to the RCSs, the mark-to-market adjustments on the RCS are not taxable/ deductible to the issuing banks. The industry requests a symmetrical tax outcome in respect of the RCSs and their hedges i.e. the above mentioned tax treatment should equally apply to the hedge positions entered into by the banking group as regards the RCSs.

HKAB hereby requests the Government to consider certain amendments to the provisions of the Bill to ensure that the intention is properly reflected in the final legislation. In addition, further guidance on the practical application of the provisions of the Bill will be required by the Inland Revenue Department, we have included certain points where we believe clarification or guidance is required.

Should you have any questions about this submission, please do not hesitate to contact Ivy Wong of the Secretariat at 2521-1169.

Yours faithfully

Doris Ma
Secretary

Enc.

c.c. Financial Services and the Treasury Bureau (Attn: Mr Jackie Liu)
Hong Kong Monetary Authority (Attn: Ms Karen Kemp)
Inland Revenue Department (Attn: Mr Brian Chiu)
Hon NG Leung-sing, SBS, JP

THE
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The Hong Kong Association of Banks' Submission to the Bills Committee on the provisions in the Inland Revenue (Amendment) (No. 4) Bill on the Tax Treatment of Regulatory Capital Securities under the Basel III Framework

1. Key industry concerns and summary of HKAB's submissions

The Inland Revenue (Amendment) (No. 4) Bill ("Bill") was introduced to the Legislative Council on 4 December 2015. The Bill, amongst others, seeks to amend the Inland Revenue Ordinance (Cap. 112) ("IRO") and Stamp Duty Ordinance (Cap. 117) ("SDO") to clarify the profits tax and stamp duty treatment in respect of qualifying regulatory capital securities ("RCSs") issued by financial institutions ("FIs") under the Banking (Capital) Rules (Cap. 155L) ("BCR") or under the equivalent laws or regulatory requirements of another member jurisdiction of the Basel Committee. Due to the implications of the Bill on the profits tax regime in Hong Kong, a Bills Committee has been established to study the Bill in detail.

Further to our previous submissions to the Financial Services and Treasury Bureau ("FSTB") (copy of the same is enclosed for you ready reference as **Appendix A**), we have received further comments from both Hong Kong incorporated FIs and Hong Kong branches of non-resident FIs in respect of the Bill.

While the Bill has been well received by the industry, we have received from our members further comments in respect of the Bill which require further consideration by the Government to ensure proper application of the legislation to bona fide regulatory capital security transactions as well as to avoid any potential conflict to the current territorial source taxation regime enshrined in the IRO. To facilitate discussion between the relevant stakeholders, the key concerns and summary of the submissions of the industry is set out in the following table:

Relevant Section(s) in the Bill	Concerns on the provision(s)	Summary of amendment(s) sought	Reference to the submission
Section 17A(2)(b), (c) and (3)	Certain limitations (e.g. convertibility into CET1, discretion for issuer to make distribution) imposed in the interpretation provisions are not consistent with regulatory requirements for the Additional Tier 1 ("AT1")/ Tier 2 ("T2") . This could lead to exclusion of RCSs issued for *bona fide* regulatory reasons.	The definition of RCSs and the relevant limitations should be amended so as to be consistent with the current market and regulatory requirements. In any case, clarification should be provided by way of Departmental Interpretation and Practice	Part 2.1

		Note ("DIPN") issued by the Inland Revenue Department ("IRD").	
Section 17F(2)	No deduction is allowed to the Hong Kong FIs issuer if the RCS issued to or held by a specified connected person is not *entirely* funded by externally issued RCS for *bona fide* commercial reasons. In case specified connected companies (e.g. act as underwriters) hold part of the externally issued RCSs for *bona fide* commercial reasons (e.g. due to under subscription by the market), the current drafting of the prescribed conditions seek to deny the entire tax deductions to the Hong Kong FIs which will give rise to unintended abrupt results.	Amendments should be made such that only proportionate amounts of interest are disallowed where prescribed conditions are not met. Further, the calculation mechanism for such disallowance needs to be prescribed (could be by way of DIPN) to remove uncertainty.	Part 2.3 and 2.4
Sections 16(2AA)	In order to facilitate orderly resolution for FIs and protect other creditors' interest, regulators [including the Hong Kong Monetary Authority ("HKMA")] may require issuances of RCS through holding companies of FIs. Under the current drafting of the Bill, issuances through these non-bank holding companies will not be eligible as RCSs and hence no tax deduction will be granted to such issuances while the interest income received by these holding companies are taxable resulting in asymmetrical tax treatment.	Amendments should be made to cover the AT1/ T2 instruments issued by financial services holding companies, especially where covered by regulatory requirements.	Part 2.2

Section 17G	A specific provision has been included in the Bill which significantly changes the basis of calculating the taxable profits of Hong Kong branches of non-resident FIs. It is a move away from the territorial source basis of taxation currently applicable in Hong Kong. This will result in a different basis of taxation for non-resident FIs and Hong Kong resident FIs.	Given the arm's length principle has been covered by Section 17E, Section 17G should not be required and hence should be removed from the Bill. Any such significant changes should only be introduced after due consideration, with a proper and thorough consultation process.	Part 3
Section 17H	The current drafting can be interpreted as codifying the arm's length and separate enterprise principles to all other taxpayers. Similar to Section 17G, this provision is also a significant change and a move away from the territorial sourced based principles of taxation and will introduce an inconsistency between Hong Kong incorporated taxpayers and non-resident taxpayers.	This provision extends beyond the remit of the current Bill on RCS and hence should be removed from the Bill. Any such significant changes should only be introduced after due consideration, with a proper and thorough consultation process with the impacted parties.	Part 4
Section 17C(2)	In arriving at the taxable profits of the issuer of RCSs, the effect of fair value accounting in relation to the RCSs is to be disregarded. It is common for FIs to hedge their financial risks (e.g. interest rate and exchange rate risks) with respect to the RCS. It is not clear that if Section 17C(2) also covers such hedge positions.	Clarification by way of DIPN that this provisions will be extended to cover hedging transactions is required to achieve a tax symmetrical outcome between interest payments on RCSs and its relevant hedging transactions.	Part 5

2. Inclusion of bona fide instruments and issuances

The current definition of "security" in the Bill may exclude certain Basel III compliant AT1 and T2 instruments which have been issued for *bona fide* regulatory reasons from qualifying as RCSs for the purposes of the Bill. In addition, *bona fide* issuances involving the holding companies of banks may not be covered by the current draft of the Bill.

2.1 AT1 and T2 instruments issued for *bona fide* regulatory reasons should qualify as RCSs

Section 17A(2) and Section 17A(3) seek to exclude certain instruments from the definition of "security" such that these instruments do not qualify for RCSs for the purposes of the Bill.

The industry is concerned that these provisions may exclude certain AT1 and T2 issued for bona fide regulatory reasons from qualifying as RCSs for the purposes of Section 17B of the Bill. In particular:

- Section 17A(2)(b) excludes "*any debt instrument the terms and conditions of which provide the issuer of the instrument <u>converting, or having an option to convert</u>, the instrument into a Common Equity Tier 1 capital instrument...*"; and
- Section 17A(2)(c)(ii) excludes any debt instrument "that provides <u>discretion to</u> the issuer of the instrument to make any distribution...that depends to any extent on the results of that business..."
- Section 17A(3) provides that the limitations under Section 17A(2)(c) do not apply if "the terms and conditions of the instrument provide for the reduction in distribution or redemption payment if the results of the business of the issuer of the instrument, or of any part of that business, worsen".

RCSs with contingent convertible features and discretion of the issuer to cancel distributions on the AT1 capital instrument are well within the qualifying criteria under Schedules 4B and 4C the BCR or the equivalent regulatory requirements of other Basel committee member jurisdictions. The above provisions however can be interpreted to exclude the application of the Bill to such AT1 and T2 instruments issued for bona fide regulatory reasons.

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 (2), we recommend that the limitation under the proposed Sections 17A(2)(b), (c) and (3) should be removed.

Without prejudice to the above request, if our recommendation of removing the limitations under Sections 17A(2)(b), (c) and (3) are not adopted, we would be glad if the IRD could confirm our interpretation of the above mentioned provisions as follows in the DIPN:

- As regards Section 17A(2)(b), with respect to AT1 and AT2 instruments that comply with the qualifying criteria stated in Schedules 4B and 4C of the BCR or the equivalent law or regulatory requirements of other Basel committee member jurisdictions, it is required under Section 1(e) of both Schedules that where there is a call option, such option may only be exercised after 5 years under certain specific scenarios which are not in control of the issuer[1]. Clarity is requested on the aspect that where a conversion that takes place within the qualifying criteria stated in the aforesaid Schedules of the BCR, it will not be captured under the proposed Section 17A(2)(b) of the Bill.

- As regards Section 17A(2)(c), clarity is requested that the regulatory requirement stated under Section 1(h) of Schedule 4B of the BCR that "dividends or coupons are only paid out of distributable items" in itself does not mean that the coupon "depends to any extent on the results of the business of the issuer" for the purposes of Section 17A(2)(c)(i). Also, that the requirement under Section 1(g) of Schedule 4B of the BCR (or under the equivalent laws or regulatory requirements) that issuers of AT1 instruments are required to have the "full discretion to cancel the distributions"[2] will not be captured under the Section 17A(2)(c)(ii).

- We would also like to obtain guidance on the meaning and intent of the language "the results of the business of the issuer of the

[1] The scenarios include (i) the issuer must have the prior consent of the HKMA; (ii) the issuer has done nothing to create an expectation at issuance that the option will be exercised; and (iii) the issuer cannot exercise, unless the issuer (a) replaces the instrument with the same or better quality capital or (b) demonstrates capital position well above the minimum standards and will remain well above after exercise.

[2] As provided under Schedule 4B of the BCR:"*(1)(g) the dividend or coupon distributions in respect of the instrument are subject to the following— (i) the institution has full discretion at all times to cancel the distributions on the instrument for an unlimited period and on a non-cumulative basis; (ii) the institution has full access to cancelled payments to meet its obligations as they fall due; (iii) the cancellation of distributions on the instrument does not constitute an event of default for the instrument; (iv) the cancellation of distributions on the instrument imposes no restrictions on the institution except in relation to distributions to ordinary shareholders;*
(h) dividends or coupons are paid only out of distributable items"

instrument, or of any part of that business, worsen" which has been included in the proposed Section 17A(3) of the Bill. Specifically, it would be helpful if the IRD can confirm that instruments with terms and conditions that allow a reduction in distribution or redemption payment upon the point of non-viability or the breaching of the capital conservation buffer will not be excluded under Section 17A(2) of the Bill.

In order to further explain the concern highlighted above, we have included as **Appendix B** the current market and/or regulatory requirements that issuers of RCSs have to observe for the Bills Committee's consideration.

2.2 Extension of scope of institutions to cover issuances made by holding companies of financial institutions

With the aim of facilitating more effective and orderly resolution in the event of a crisis, requirements imposed by a number of regulators, including the HKMA and those in the United States and the United Kingdom ("UK"), increasingly leading to banks to issuing regulatory capital externally at the holding company level and then provide such capital to operating subsidiaries through intra-group instruments. In the Financial Institutions (Resolution) Bill[3] which was introduced into the Legislative Council in December 2015, it is recommended 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. Under this circumstance, the HKMA may request AT1/T2 instruments to be issued through Hong Kong non-bank financial service holding company ("Holding Company") which is not FI as defined in the IRO and hence coupon payments on such AT1/T2 instruments would not be eligible for tax deduction under the proposed provisions under the Bill creating asymmetrical tax treatment.

Under Sections 16(2AA) and 17B of the Bill, tax deduction of distributions on RCS ties back to the existing provisions of Sections 16(1)(a) and 16(2)(a) of the IRO. Section 16(2)(a) of the IRO applies to a "financial institution"[4] which is defined in Section 2 of the IRO as

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[3] A copy of the bill can be retrieved from the following website: http://www.legco.gov.hk/yr15-16/english/bills/b201511201.pdf.

[4] Financial institution (財務機構), means-
(a) an authorized institution within the meaning of section 2 of the Banking Ordinance (Cap 155);
(b) any associated corporation of such an authorized institution which, being exempt by virtue of section 3(2)(a) or (b) or (c) of the Banking Ordinance (Cap 155), would have been liable to be authorized as a deposit-taking company or restricted licence bank under that Ordinance had it not been so exempt.

broadly a bank, and hence, in order to claim a tax deduction under the Bill as currently proposed, the issuer needs to be a FI.

In a scenario, where RCS are issued by a Hong Kong Holding Company which then provides such capital to an intra-group bank, unless the Hong Kong Holding Company is included within the definition of FI, no deduction on RCS will be allowed to this entity while any coupon payments by the bank shall be taxable in the hands of the Hong Kong Holding Company under the Bill as currently proposed. This will create an "asymmetrical tax outcome" for the Hong Kong Holding Company.

Therefore, we request that the legislation to include a sub-section in the Bill to cover RCS to be issued by Hong Kong 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.

2.3 Amendments to Section 17F(2) to cover holdings by specified connected person for bona fide commercial reasons

It is common for banking groups to have group entities providing full range of financial services relating to the external issuance of RCSs by the group. For instance, a specified connected person may end up holding some RCS for a period of time in performance of underwriting or sub-underwriting activities in case of under-subscription by the public.

Under the proposed Section 17F(2), two conditions have to be satisfied for issuers (e.g. Hong Kong FIs) to obtain a (full) deduction in respect of RCS issued to, held by or issued or held for the benefit of their specified connected persons:

- "the money paid by or on behalf of the specified connected person for the issue of the regulatory capital 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 that the specified connected person or an associated corporation of the specified issuer"; and

- "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".

Where one of the above conditions is not met, the coupon payments will be "fully" disallowed, i.e. deduction under the currently proposed Bill is either all or none under the current drafting which give rise to unintended abrupt results. To avoid a full disallowance of coupon payments incurred by FI issuers of RCS where (i) the RCSs are not entirely externally funded or (ii) at any time during the assessment year of the issuers, a portion of the externally issued RCS or any backing instruments are held by specified connected persons for bona fide commercial reasons as stated above, we would like to request the proposed Section 17F(2) to be amended as follows to allow pro-rata deduction of interest:

"(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 ***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 ***funded****, either directly or indirectly, by the proceeds of an external issue of a regulatory capital security, or debenture or debt instrument by that specified connected person or an associated corporation of the specified issuer; and*

(b) the externally issued regulatory capital security, or debenture or debt instrument, ,is not ***held for the benefit of*** *a specified connected person of the specified issuer."*

2.4 **Clarification on tracing the funding of sums payable in respect of RCSs by the specified connected person to the issuer is funded by the proceeds of an external issuance for the purpose of Section 17F(2)(a)**

Due to fungibility of funds, it is practically difficult for FIs, as required under Section 17F(2)(a), to trace the flow of specific funds to demonstrate that the money paid by the specified connected person to the issuer is funded by the proceeds of an external issue of RCS for the following reasons:

- Typically any external issuance for a banking group has to be justified by the need to raise additional capital and will usually be subject to group capital requirement and capital market conditions/appetite. As such, there will rarely be a one for one issuance out of a global headquarter specifically for an individual subsidiary within the banking group.
- There may be timing mis-match between group external issuances and the capital being "pushed-down" depending on the capital market conditions and the regulatory capital requirements of the individual banking entities under the group.

In this regard, practical guidance in the DIPN will be needed from the IRD as to how Section 17F(2)(a) is to be applied / it's impact measured, to cover the *bona fide* commercial situations that may arise. We would recommend that the IRD may take two approaches in arriving at the amount of tax deduction to be granted to a FI. The preferred approach would be to allow tax deduction on distributions with respect to RCS to the extent that the amount of regulatory capital issued by a FI in Hong Kong to its associated corporations is less than that issued externally by the group holding entity. This approach is simple and easy to apply which allows the FI to trace the coupon rate of the external issuance to ensure the application of Section 17F(2).

The alternative approach would be a proportional approach:

- Calculate the balance of regulatory capital issued externally out of the holding entity (Amount A).
- Calculate the balance of regulatory capital issued intra-group across the worldwide consolidated group (Amount B).
- If Amount A is greater than or equal to Amount B, the amount of allowable deduction to be claimed by a FI should not be limited for that basis period.
- If Amount A is less than Amount B, then the amount of deduction to be granted to a FI should be limited to a proportion of Amount A based on its relative proportion of Amount B for that basis period.

This approach is more complicated and further guidance and examples would be required by the IRD to cater for different scenarios. For instance, what coupon rate for external issuance should by adopted by the FI in cases where there are multiple external issuances with different coupon rates (due to prevailing market conditions at the time of each issuance) by the connected person during a basis period.

3. **Removal of the application of the separate enterprise principle for non-resident FIs' Hong Kong branch under Section 17G**

Section 17G(1) of the Bill will apply to ascertain the taxable profits of a non-resident FIs' Hong Kong branch. Section 17G will result in a significant and material change to the manner in which non-resident FIs are taxed in Hong Kong and will result in a change in the basis of taxation in Hong Kong from a territorial sourced based taxation system for non-residents to a system that determines taxable profits based upon an approach similar to the authorized Organisation for Economic Co-operation and Development ("OECD") approach ("AOA")[5] in attributing profits to permanent establishments ("PEs"). It is the

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

industry's concern that rather than providing consistency between Hong Kong incorporated taxpayers and non-resident taxpayers, Section 17G of the Bill will create two distinct basis of taxation.

Given that this is a significant change and a move away from the territorial sourced principles of taxation in Hong Kong and will introduce an inconsistency between Hong Kong incorporated taxpayers and non-resident taxpayers, we strongly recommend that the Government give the proposal due consideration with a proper and thorough consultation process.

Section 17G(2) to 17G(3) of the Bill seek to treat the Hong Kong branch of the non-resident FI as a distinct and separate enterprise in ascertaining its taxable profits in Hong Kong. The proposed Section 17G will implement the AOA in attributing profits to PEs including branches. The AOA hypothesizes that the PE is a separate and distinct legal entity from its head office, as in the case of a parent/ subsidiary relationship. Based on this hypothesis transfer pricing rules can then be applied to the PE based on the functions performed, assets used and risk assumed.

The Legislative Council Brief on the Bill (File Ref: B&N/2/1/66C) states that Section 17G (together with Section 17H) aims to specify the application of the arm's length and the separate enterprise principles in ascertaining profits in respect of RCSs for anti-avoidance purposes. However Section 17G, along with Section 17H as drafted are significantly wider and will fundamentally change the basis to determine the profits chargeable to tax in Hong Kong of non-residents. This is set out in more detail in **Appendix C**.

Given Section 17E of the Bill has already imposed the arm's length requirement in connection with RCSs, if it is the Government's intention to confine the application of Section 17G to sums payable in respect of RCSs for non-resident FI's Hong Kong branch, Section 17G is not be required and hence we respectfully request that this Section be removed from the Bill and be introduced only after careful deliberation and comprehensive consultation with the industry.

4. **Removal of the application of the arm's length and separate enterprise principles to taxpayers other than in the context of RCS under Section 17H**

Section 17H of the Bill as currently drafted can possibly be interpreted as codifying the AOA approach and transfer pricing legislation into the IRO and extend the application to all non-FI and non-RCS issuing taxpayers in Hong Kong which is clearly outside the intended purposes of the current Bill.

Given that this is a significant change and a move away from the sourced based principles of taxation and will introduce an inconsistency between Hong Kong incorporated taxpayers and non-resident taxpayers we strongly recommend that the Government remove Section 17H from the Bill and only introduce the AOA and broad based transfer pricing provisions after due consideration and wider industry consultation.

5. Clarification that Section 17C of the Bill also covers relevant hedging transactions

As included in our previous submission to the FSTB dated 6 November 2015, it is common for banks to hedge their financial risks (e.g. interest rate and exchange rate risks) with respect to the RCSs. For example, an FI with a functional currency of HKD may issue a RCS in USD and hedge the exchange rate risks 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.

The proposed Section 17C in the Bill seeks to ensure that, in ascertaining the profits of the issuer of the RCS with respect to the RCS, such profits are to be determined on a realized basis such that the mark-to-market ("MTM") adjustments are not taxable/ deductible to the issuing banks.

To ensure a symmetrical tax outcome in respect of the RCS and its hedges, we would like to seek a clarification to be made by way of an example in the DIPN that the proposed Section 17C in the Bill also covers MTM gains or losses on hedges with respect to the RCS, no matter issued by Hong Kong FIs, or where the hedge with the Hong Kong FI is meant for similar RCS issuances within the banking group. This should be consistent with the IRD's view[6] and the approach taken by the UK[7].

[6] As demonstrated in paragraph 38 of the DIPN No.42, that to the extent that hedge accounting is adopted, "*the hedged item and the hedging instrument should not be considered separately because hedging is an attempt to mitigate the impact of economic risks of the hedged items*".

[7] As illustrated in paragraph 3.3 of the Policy Paper titled "Draft legislation: the taxation of regulatory capital securities regulations 2013" issued by the HM Revenue & Customs on 13 February 2014, the fair value profit and losses on the instrument to be recognized in respect of a designated hedging relationship in relation to a RCS are disregarded from a UK tax perspective.

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Dear Mr Liu

Comments on the draft provisions of the Inland Revenue (Amendment) Bill on the Tax Treatment for Regulatory Capital Securities under the Basel III Framework

We very much appreciate the efforts and the work done by The Government of the Hong Kong Special Administrative Region ("Government") to date in coming up with the draft provisions of the Inland Revenue (Amendment) Bill with respect to the Tax Treatment for Regulatory Capital Securities under the Basel III Framework ("Draft Provisions").

We welcome the opportunity to comment on the Draft Provisions to be introduced into the Inland Revenue Ordinance and the Stamp Duty Ordinance.

As mentioned in our previous submissions to the Bureau dated 8 August 2014 and 18 December 2014, we would like to reiterate that it is the industry's objective to obtain certainty in the Hong Kong tax treatment on regulatory capital instruments qualifying under the Banking (Capital) Rules (Cap. 155L). In this connection, the Draft Provisions have been well received by the industry as they generally align the tax treatment for certain qualifying regulatory capital securities with the corresponding tax legislations in some other international financial centers such as London and Singapore, which is essential to maintain a level playing field for financial institutions in Hong Kong vis-à-vis their peers in the other international financial centers.

As discussed in our meeting with the Government's representatives on 22 October 2015, we have received from our members comments on various key aspects of the Draft Provisions which require further consideration by the Government to ensure proper application of the legislation to bona fide regulatory capital security transactions. These comments are summarized in the paper enclosed ("Enclosed Submission"). In addition, as we understand further guidance on the practical application of the Draft Provisions will be issued by the Inland Revenue Department we have attempted to include in the Enclosed Submission the points on which we would like to seek clarification or guidance.

Accordingly, the Enclosed Submission has been presented in two parts i.e. Part A contains those comments where we believe an amendment to the draft legislation is required and Part B contains those comments where we believe clarification is appropriate by way of a Departmental Interpretation and Practice Notes to achieve the Government's intent in regard to the Draft Provisions.

HKAB remains available to discuss the specific matters mentioned in this letter, and we would welcome the opportunity to meet with you before finalisation of the draft Bill, to the extent that it would be helpful in ensuring that our points are adequately addressed.

Yours sincerely

Henry Chan
Secretary

Enc.

c.c. Hong Kong Monetary Authority (Attn: Ms Karen Kemp)
Inland Revenue Department (Attn: Mr Brian Chiu)

The Hong Kong Association of Banks' Submission to the Financial Services and the Treasury Bureau on the draft provisions in the Inland Revenue (Amendment) Bill on the Tax Treatment for Regulatory Capital Securities under the Basel III Framework

Introduction

In response to the draft provisions to be introduced into the Inland Revenue Ordinance ("IRO") and the Stamp Duty Ordinance through the Inland Revenue (Amendment) Bill on the Tax Treatment for Regulatory Capital Securities under the Basel III Framework ("Draft Provisions") issued by the Financial Services and the Treasury Bureau ("FSTB") on 9 October 2015, we have set out below the comments received from our members on the Draft Provisions and the points for clarification as discussed in our meeting on 22 October 2015 ("Meeting") with the representatives from The Government of the Hong Kong Special Administrative Region ("Government").

We have split the comments between, those where we believe an amendment to the draft legislation is required (i.e. Part A) and those where we believe clarification is appropriate by way of a Departmental Interpretation and Practice Notes ("DIPN") to achieve the Government's intent in regard to the Draft Provisions (i.e. Part B).

Part A – Amendments requested to the Draft Provisions

Extension of scope of institutions to cover issuances made by holding companies of financial institutions

With the aim of facilitating more effective and orderly resolution in the event of a crisis, requirements imposed by a number of regulators, including the Hong Kong Monetary Authority ("HKMA")[1] and those in the United States and the United Kingdom ("UK"), increasingly leading to banks to issuing regulatory capital externally at the holding company level and then downstream such capital to operating subsidiaries through intra-group instruments. In addition, there are circumstances where a financial institution may be required by the HKMA to issue regulatory capital securities and other debt instruments through a Hong Kong non-bank holding company ("Holding Company") which is not a financial institution as defined in Section 2 of the IRO.

Under Sections 16(4B) and 17B of the Draft Provisions, tax deduction of distributions on regulatory capital securities ("RCS") ties back to the existing provisions of Sections 16(1)(a) and 16(2)(a) of the IRO. Section 16(2)(a) of the IRO applies to a "financial

[1] In the Consultation Paper and Second Consultation Paper regarding "An Effective Resolution Regime for Financial Institutions in Hong Kong" jointly published by the FSTB, HKMA, the Securities and Futures Commission and the Insurance Authority, it is recommended under certain conditions, resolution of a failing financial institution 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.

institution"[2] which is defined in Section 2 of the IRO as broadly a bank, and hence, in order to claim a tax deduction under the Draft Provisions as currently proposed, the issuer needs to be a financial institution.

In a scenario, where RCS are issued by a Hong Kong Holding Company which then downstream to a bank, unless the Holding Company is included within the definition of financial institution, no deduction on RCS will be allowed to this entity while any coupon payments by the bank shall be taxable in the hands of the Holding Company under the Draft Provisions as currently proposed. This will create an "asymmetrical tax outcome" for the Holding Company.

Therefore, we request that the legislation to include a sub-section in the Draft Provisions to cover RCS to be issued by Holding Companies to the extent that the recommendations under the Resolution Regime for Financial Institutions in Hong Kong are applicable to financial institutions and their Holding Companies in Hong Kong[3].

Lifting of the limitation on the qualifying "RCS" under Sections 17A(3)(b), (c)and (4)

The proposed Sections 17A(3) and (4) in the Draft Provisions impose certain limitations on the security eligible for debt categorization under the Section 17B. In particular,

- Section 17A(3)(b) excludes "*any instrument the terms and conditions of which entitle*[4] *the issuer of the instrument to convert or to opt to convert the instrument into a Common Equity Tier 1 capital instrument*..."; and
- Section 17A(3)(c)(ii) excludes "*any instrument that provides discretion to the issuer of the instrument to make any distribution...that depends to any extent on the results of that business...*"

As contingent convertible features and discretion of the issuer to cancel distribution for AT1 capital instrument are within the qualifying Basel III criteria under Schedules 4B and/or 4C of the Banking Capital Rules ("BCR") or the equivalent law or regulatory requirements of other Basel committee member jurisdictions, the above provisions may create uncertainty to the application of the legislation. Certainty in this regard is imperative particularly where Section 17F requires RCS issued by a bank to non-resident connected person to be funded by the proceeds of an external issue of RCS. Due to varying adoption of Basel III across the world, terms and conditions of the

[2] Financial institution (財務機構), means-
(a) an authorized institution within the meaning of section 2 of the Banking Ordinance (Cap 155);
(b) any associated corporation of such an authorized institution which, being exempt by virtue of section 3(2)(a) or (b) or (c) of the Banking Ordinance (Cap 155), would have been liable to be authorized as a deposit-taking company or restricted licence bank under that Ordinance had it not been so exempt.

[3] According to the Minutes of meeting held by the Legislative Council ("LegCo") dated 2 March 2015 (LC Paper No. CB(1)844/14-15), it is expected that the relevant legislative proposals for the establishment of the proposed resolution regime will be introduced into the LegCo by the end of 2015.

[4] According to the Black's Law Dictionary, "entitle" means "to grant a legal right to or qualify for" and "entitlement" means "an absolute right to a (usu. monetary) benefit, such as social security, granted immediately upon meeting a legal requirement".

individual bona fide external issuance of RCS may vary but this should not preclude these issuance from the definition of RCS so long as it satisfies the Basel III capital requirements as set out by the home regulator of the foreign banks. Otherwise, this may inadvertently limit the application of Section 17B to bona fide issuance of RCS which defeats the purpose of the legislation.

For clarity sake, given the Draft Provisions have already limited the application of the proposed Section 17B to "RCS" as defined under the proposed Section 17A(2) and related definitions proposed in (5), we recommend that the limitation under the proposed Sections 17A(3)(b), (c) and (4) should be lifted.

Amendments to the proposed Section 17F

Section 17F(1)(b) to cover holdings by connected person for bona fide commercial reasons

It is common for banking groups to have entities providing asset management, private banking or custodial services in which, as part of their ordinary business, they may hold RCS in the capacity as a nominee for the benefits of their funds or underlying customers.

Under the proposed Section 17F(1)(b), two conditions have to be satisfied for issuers to obtain a full deduction in respect of RCS issued to or held by or for the benefit of a connected person who is not chargeable to Hong Kong profits tax:

- "the money paid by that connected person for the regulatory capital security has been entirely funded, either directly or indirectly, by the proceeds of an external issue of a regulatory capital security, or debenture or instrument by that connected person or an associated corporation of the issuer"; and
- "neither the externally issued regulatory capital security, or debenture or instrument nor any part of it is, at any time during the basis *period of the issuer for the year of assessment concerned, held by or for the benefit of* a *connected person*"

To avoid disallowance of coupon payments incurred by issuers of RCS due to holding of these RCS or any backing instruments for bona fide commercial reasons as stated above, we would like to request the proposed Section 17F(1) to be amended as follows:

- *"(1) No deduction is to be allowed to the issuer under section 16(1) to the extent that the sum payable, during the basis period for any year of assessment, in respect of any regulatory capital security issued to and held for the benefit of, a connected person of the issuer unless –*
  (a) the connected person is chargeable to tax under this Ordinance in respect of the sum; or
  (b) both of the following conditions are met –
  (i) the money paid by that connected person for the regulatory capital security has been funded, either directly or indirectly, by the proceeds of an external issue of a

regulatory capital security, or debenture or instrument by that connected person or an associated corporation of the issuer; and
(ii) neither the externally issued regulatory capital security, or debenture or instrument nor any part of it is, at any time during the basis period of the issuer for the year of assessment concerned, held for the benefit of a connected person."

Section 17F(6) to be removed from the Draft Provisions

In light of the above discussion and the amendment suggested in respect of Section 17F(1), which imposes specific restrictions for tax deduction in the hands of the issuer as regards the sums payable in respect of RCS held for the benefit of a connected person, Section 17F(6) in its current form is made redundant and carries the risk of being interpreted in a manner that could complicate the issue. We therefore request that Section 17F(6) be removed from the Draft Provisions.

Inclusion of safe harbor rules for holding of RCS by an associated corporation on a short term basis for underwriting or for market making purposes

In addition to the above, other associated corporations within the banking group may also hold the RCS issued by a financial institution in the ordinary course of their business to facilitate capital market transactions such as underwriting and secondary market making or trading activities.

For the benefit of developing the bond market in Hong Kong and to avoid disapplication of the legislation to bona fide capital market transactions, it is essential that safe harbor rule be introduced to cater for such circumstances where associated corporations may hold RCS. For the purpose of Section 17F(1)(b)(ii), we recommend a safe harbor rule be provided whereby a tax deduction is allowed in cases where the holding of RCS are held for the benefits of the connected persons of the issuer:-

- for less than a prescribed time period, say less than one year to cater for underwriting activities; or
- below a de minimis holding threshold, say 5% of the total amount of the respective outstanding RCS[5] ,to cater for market making activities.

Exclusion of the insurance entities within banking groups as connected person

Many banking groups have associated insurance entities, where in order to fund future insurance claims, these associated insurance entities may invest into RCS issued by the banking entity as part of their investment portfolio in addition to other securities.

[5] Reference can be made to the Regulation (EU) No. 241/2014 - Supplementing Regulation (EU) No 575/2013 of the European Parliament (i.e. CRR) and of the Council with regard to regulatory technical standards for Own Funds requirements for institutions where the predetermined holding threshold for AT1 or T2 instruments shall not exceed the lower of the following amounts:
(1) 10% of the amount of the relevant issuance; or
(2) 3% of the total amount of outstanding AT1 instruments or T2 instruments, as applicable.

Under the proposed Section 17F(7)(b) in the Draft Provisions, certain entities are excluded from the definition of "connected person" and hence the tax deduction to be obtained by the issuer of the RCS should not be affected where these securities are issued to, held by or for the benefit of these entities. The current drafting of Section 17F in the Draft Provisions may disallow a tax deduction to the issuer if any of its RCS are held by its associated insurance entities [where the prescribed specific conditions under Section 17F(1)(a)/(b) of the Draft Provisions are not satisfied].

In this regard, we would like to suggest the inclusion of insurance entities, which may be part of a banking group issuing RCS in Hong Kong, to the extent that any insurance entity invests in RCS as part of its investment portfolio, in the list under Section 17F(7)(b) such that they are not considered as "connected person" in ascertaining the amount of deduction to be allowed for the issuing financial institutions.

<u>Amendments to Section 17G to limit the application of the arm's length principle to any sum payable in respect of a RCS</u>

Section 17G of the Draft Provisions proposes to treat the Hong Kong branch of a non-resident financial institution ("FI") as a distinct and separate enterprise where transactions between such branch and any other part of the non-resident FI are treated as taking place on such terms and conditions as would have been agreed between parties dealing at arm's length. This section shall apply in ascertaining the profits chargeable to tax in Hong Kong in respect of such FIs.

Section 17G is a significant change in the manner in which Hong Kong determines the taxable profits of bank branches in Hong Kong. While we understand the intention is to limit this approach to the calculation of the profits in respect of regulatory capital, under the current drafting it appears to be a significant move away from Hong Kong's sourced based taxation principles under the IRO, to determining the profits chargeable to tax in Hong Kong based on the residence-based system of taxation as enshrined in Hong Kong's Double Taxation Agreements.

Accordingly, we request that the Section be amended such that it merely is applied to determine the tax treatment of any sum "payable" by a non-resident FI's Hong Kong branch in respect of RCS. We have explained the rationale for this request in more detail in *Appendix A.*

In addition, where the approach similar to the proposed Section 17G has been adopted by overseas jurisdictions (e.g. Australia), there is a consequential adjustment to the taxable profits of resident entities in their country of residence in respect of the adjustment in the overseas branch's taxable profits. This is to ensure, where interest expenses incurred by the overseas branch are disallowed by the overseas tax authority due to the arm's length adjustment as proposed under Section 17G, a corresponding adjustment will be made to the profits of the resident entity in the host jurisdiction. In the absence of such an adjustment, which is the case of the current drafting of the proposed Section 17G, double taxation would arise.

Therefore, we request that the Government consider revising the proposed Section 17G to read as follows, or something similar:

*"**17G. Financial institution provisions: Tax treatment of any sum payable in respect of a regulatory capital security by non-resident financial institution's Hong Kong branch***

(1) This section applies in ascertaining any sum payable in respect of a regulatory capital security issued by a non-resident financial institution's Hong Kong branch which is tax deductible under this Part when computing the non-resident financial institution's profits chargeable to tax in Hong Kong.

(2) Any sum payable in respect of a regulatory capital security between the Hong Kong branch and any other part of the non-resident financial institution is to be treated as distributed on such terms and conditions as would have been agreed between parties dealing at arm's length.

(3) In this section –
***non-resident financial institution** ( ) means any financial institution whose head office is situated elsewhere than in Hong Kong;*
***Hong Kong branch** ( ) means any business carried on in Hong Kong by a non-resident financial institution."*

We would also appreciate if the IRD can provide further guidance on the application of the proposed Section 17G by way of an example in the anticipated DIPN.

Notwithstanding the above submission, if it is the Government's intent to adopt a broader application of Section 17G as originally proposed in the Draft Provisions, a separate industry consultation should be conducted as this is a significant change from Hong Kong's sourced based taxation principles enshrined under the IRO to a residence-based system of taxation.

<u>Removal of the application of the arm's length principle to taxpayers other than in the context of RCS under Section 17H</u>

We would like to clarify the intent of the Government with respect to the proposed Section 17H in the Draft Provisions where it is stated that "*<u>nothing</u> in Section 17E or 17G is to read as preventing principles similar to those provided for in those sections from applying to a person that is <u>not a financial institution</u> or from applying <u>otherwise than in connection with a regulatory capital security</u>*".

Based on our reading of this Draft Provision, the Section as it has been currently drafted may be interpreted in a manner that its applicability expands beyond the financial institutions issuing RCS and may cover other Hong Kong taxpayers. If this is the Government's intention, the principles stated in Section 17H in the Draft Provisions should be issued by way of a separate legislative proposal and be subject to a wider industry consultation. This could be considered as part of Hong Kong's review of the impact of final reports on the Organisation for Economic Co-operation and Development ("OECD")'s Base Erosion and Profit Shifting project.

In order to avoid any controversy as regards the interpretation of this proposed Section, we recommend that this proposed Section be removed to restrict the applicability of Section 17E or 17G to only financial institutions issuing RCS.

Part B – Clarifications requested by way of DIPN

In addition to the above comments, as we understand further guidance on the practical application of the Draft Provisions will be issued by the Inland Revenue Department ("IRD"), we have stated below the specific sections in the Draft Provisions on which we would like to seek further guidance or clarification.

Clarification of the scope of RCS under Section 17A(2) in the Draft Provisions

We would like to seek clarification on the definition of the term "regulatory capital security". Specifically, the current drafting of proposed Section 17A(2) in the Draft Provisions suggest inclusion of Additional Tier 1 capital instrument ("AT1") and Tier 2 capital instrument ("T2") issued for the purposes of "the Banking (Capital) Rules (Cap. 155 sub. Leg. L) *or the equivalent law or regulatory requirements of another member jurisdiction of the Basel Committee*". There has been varying adoption of Basel III across the world and it is possible for regulators not to fully follow the Basel III regime as introduced by the Basel Committee. As such, guidance and examples from the IRD may be required to ring-fence the scope of application of the Draft Provisions and to provide certainty as regards the application of these Draft Provisions.

In addition, we would like to confirm that in respect of debt instruments that do not fall under the scope of "regulatory capital security" in the Draft Provisions, the existing principles (i.e. Sections 16(1)(a) and 16(2) of the IRO) apply in governing the deduction of interest expenses.

Clarification of the exclusion tests under Sections 17A(3)(b),(3)(c) and (4)

Section 17A(3)(b) in the Draft Provisions excludes "*any instrument the terms and conditions of which entitle the issuer of the instrument to convert or to opt to convert the instrument into a Common Equity Tier 1 capital instrument...*". and Section 17A(3)(c) in the Draft Provisions excludes any instrument that provides (i) the investor a contractual right to any distribution or redemption; or (ii) the issuer the discretion to make any distribution or redemption payment, to the extent that the contractual right or discretion depends on the results of the business of the issuer.

For the avoidance of doubt, if our recommendation of lifting the limitations under Sections 17A(3) and (4) are not adopted, we would be glad if the IRD could confirm our interpretation of the above mentioned provisions as follows in the DIPN:

- As regards Section 17A(3)(b), with respect to AT1 and AT2 instruments that comply with the qualifying criteria stated in Schedules 4B and 4C of the BCR, it is required under Section 1(e) of both Schedules that where there is a call option, such option may only be exercised after 5 years under certain specific scenarios which are not in control of the issuer[6]. Given the specific conditions under which a conversion takes place, in our view no absolute "entitlement" exists until such conditions have been satisfied and hence, instruments with contingent convertible features, which fall under the qualifying criteria stated in Section 1(e) of Schedules 4B and 4C of the BCR will not be captured under the proposed Section 17A(3)(b).

- As regards Section 17A(3)(c) that the regulatory requirement stated under Section 1(h) of Schedule 4B of the BCR that "dividends or coupons are only paid out of distributable items" in itself does not mean that the coupon "depends to any extent on the results of the business of the issuer" and that the requirement under Section 1(g) of Schedule 4B of the BCR that issuers of AT1 instruments are required to have the "full discretion to cancel the distributions"[7] will not be captured under the proposed Section 17A(3)(c)(ii).

In addition to the above, if our recommendation of lifting the limitations under Sections 17A(3) and (4) are not adopted, we would also like to obtain guidance on the meaning and intent of the language that "the results of the business of the issuer of the instrument or of any part of that business worsen" included in proposed Section 17A(4) of the Draft Provisions. Specifically, it would be helpful if the IRD can confirm that instruments with terms and conditions that allow a reduction in distribution or redemption payment upon the point of non-viability or the breaching of the capital conservation buffer will not be excluded under Section 17A(3) in the Draft Provisions.

<u>Extension of the proposed Section 17C to cover relevant hedging transactions</u>

It is common for banks to hedge their financial risks with respect to the RCS (for example, where the security is issued in USD but where the functional currency of the bank is in HKD). Where there is a designated hedging transaction with respect to a RCS, fair value profit and losses may arise from both the security and the hedge.

We understand that the proposed Section 17C seeks to ensure that, in ascertaining the profits of the issuer of the RCS with respect to the RCS, such profits are to be determined on a realized basis such that the mark-to-market ("MTM") adjustments are not taxable/ deductible to the issuing banks pursuant to proposed Section 17C in the Draft Provisions.

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[6] The scenarios include (i) the issuer must have the prior consent of the HKMA; (ii) the issuer has done nothing to create an expectation at issuance that the option will be exercised; and (iii) the issuer cannot exercise, unless the issuer (a) replaces the instrument with the same or better quality capital or (b) demonstrates capital position well above the minimum standards and will remain well above after exercise.

[7] As provided under Schedule 4B of the BCR:"*(1)(g) the <u>dividend or coupon distributions</u> in respect of the instrument are subject to the following— (i) the institution has <u>full discretion</u> at all times to cancel the distributions on the instrument for an unlimited period and on a non-cumulative basis; (ii) the institution has full access to cancelled payments to meet its obligations as they fall due; (iii) the cancellation of distributions on the instrument does not constitute an event of default for the instrument; (iv) the cancellation of distributions on the instrument imposes no restrictions on the institution except in relation to distributions to ordinary shareholders;*
(h) dividends or coupons are <u>paid only out of distributable items</u>"

To ensure a symmetrical tax outcome in respect of the RCS and its hedges, we would like to seek confirmation from the IRD on whether the tax treatment proposed under Section 17C in the Draft Provisions will also include MTM gains or losses on hedges with respect to the RCS, no matter issued by Hong Kong financial institutions, or where the hedge with the Hong Kong financial institution is meant for similar RCS issuances within the banking group. This should be consistent with the IRD's view, as demonstrated in paragraph 38 of the DIPN No.42, that to the extent that hedge accounting is adopted, "*the hedged item and the hedging instrument should not be considered separately because hedging is an attempt to mitigate the impact of economic risks of the hedged items*".

Please note this is also the approach taken by the UK. As illustrated in paragraph 3.3 of the Policy Paper titled "Draft legislation: the taxation of regulatory capital securities regulations 2013" issued by the HM Revenue & Customs on 13 February 2014, the fair value profit and losses on the instrument to be recognized in respect of a designated hedging relationship in relation to a RCS are disregarded from a UK tax perspective.

<u>Holding Company of financial institution to be treated as "flow through" for the purpose of Section 17E</u>

The proposed Section 17E in the Draft Provisions implements an "arm's length requirement" where adjustments are to be made to the profits accrued to a person in relation to a qualifying RCS if the conditions made or imposed between a financial institution and its associate are different from those that would be made between independent unrelated parties.

As stated above, for various regulatory and recovery resolution reasons driven by regulatory authorities including the HKMA, financial institutions may be required to issue RCS through Holding Companies. Assuming the asymmetry issue is addressed by including Holding Companies in the revised Draft Provisions, the application of the proposed Section 17E in the Draft Provisions may result in adjustments to coupon payments made by Holding Companies to financial institutions for tax purposes due to the difference in the entity credit ratings between Holding Companies and financial institutions.

Given the downstream of the RCS by the Holding Companies to financial institutions is already subject to HKMA's approval, the Holding Companies should be assumed to have same credit rating as the respective financial institutions for ascertaining the tax deductible cost of RCS under the arm's length principles for Hong Kong profits tax purposes.

Confirmation that multiple layers of issuance are allowed under Section 17F(1)

With respect to overseas headquartered banks with Hong Kong incorporated banking subsidiaries for regulatory and other commercial reasons[8], there are often multiple corporate layers between the entity issuing the RCS externally and the Hong Kong financial institution. The following is an example of a likely scenario (assuming the HKMA requires a holding by the Hong Kong non-bank Holding Company under the proposed resolution regime for financial institutions in Hong Kong as discussed) where UK Hold Co (issuing entity) owns 100% of UK Bank Co who holds 100% of HK Hold Co who in turn owns 100% of the Hong Kong financial institution.

External issuance

UK Hold Co

UK Bank Co

HK Hold Co

Hong Kong Financial Institutions

It is not clear under Section 17F(1) in the Draft Provisions whether down-streaming of externally issued RCS would be accommodated and whether issuer's deduction will be limited under such circumstances.

Therefore, we would like to confirm that by including the language "directly or indirectly" under the proposed Section 17F(1)(b)(i) in the Draft Provisions, a multiple-layered structure as illustrated above will be covered such that a tax deduction on distributions on RCS will be available to the Hong Kong issuer (i.e. Hong Kong financial institution).

Practical application of the tests under Section 17F(1)

Section 17F(1) in the Draft Provisions seeks to limit a tax deduction for an issuer of a RCS where the security is issued to and held for the benefits of a connected person and requires that connected person to be chargeable to profits tax in Hong Kong or the satisfaction of both conditions that the money paid by the person for the security has been funded by an external issuance and that the externally issued instrument in

[8] In addition to the regulatory drivers, regulatory capital issued directly to the market by a non-wholly owned subsidiary will be discounted or disregarded in the calculation of group capital resources, which creates incentives to issue capital higher up the group and then down-stream to the relevant operating subsidiaries.

support of the RCS is not held partly or wholly at any time for the benefit of a connected person.

Due to fungibility of funds, it is practically difficult for financial institutions to trace the flow of specific funds to demonstrate that the money paid by the connected person to the issuer is funded by the proceeds of an external issue of RCS for the following reasons:

- Typically any external issuance for a banking group has to be justified by the need to raise additional capital and will usually be subject to group capital requirement and capital market conditions/appetite. As such, there will rarely be a one for one issuance out of a global headquarter specifically for an individual subsidiary within the banking group.
- There may be timing mis-match between group external issuances and the capital being "pushed-down" depending on the capital market conditions and the regulatory capital requirements of the individual banking entities under the group.

In this regard, practical guidance will be needed from the IRD as to how the above test is to be applied to cover the bona-fide commercial situations that may arise. We would recommend that the IRD may take two approaches in arriving at the amount of tax deduction to be granted to a financial institution. The preferred approach would be to allow tax deduction on distributions with respect to RCS to the extent that the amount of regulatory capital issued by a financial institution in Hong Kong to its associated corporations is less than that issued externally by the group holding entity. This approach is simple and easy to apply which allows the financial institution to trace the coupon rate of the external issuance to ensure the application of Section 17F(2).

The alternative approach would be a proportional approach:

- Calculate the balance of regulatory capital issued externally out of the holding entity (Amount A).
- Calculate the balance of regulatory capital issued intra-group across the worldwide consolidated group (Amount B).
- If Amount A is greater than or equal to Amount B, the amount of allowable deduction to be claimed by a financial institution should not be limited for that basis period.
- If Amount A is less than Amount B, then the amount of deduction to be granted to a financial institution should be limited to a proportion of Amount A based on its relative proportion of Amount B for that basis period.

This approach is more complicated and further guidance and examples would be required by the IRD to cater for different scenarios. For instance, what coupon rate for external issuance should by adopted by the financial institution in cases where there are multiple external issuances with different coupon rates (due to prevailing market conditions at the time of each issuance) by the connected person during a basis period.

Operation of transitional provisions under Schedule xx

For T2 capital instruments issued previously, many banks have been claiming the distributions as tax deductible in filing their profits tax returns on the basis that T2 capital instruments should be treated as debt for Hong Kong profits tax purposes and the IRD has not disputed this tax treatment so far.

However, according to the transitional rules in Schedule xx, the proposed debt and interest treatment only applies to "*sums payable... on or after 1 April 2016*". It will be unfair and administratively burdensome if the IRD were to apply the proposed transitional rules under Schedule xx and disallow distributions which had been made pursuant to previously issued T2 instruments.

We would urge the IRD to make it clear in the DIPN that in respect of T2 securities that qualified under the BCR and are legal form debt, the Draft Provisions merely clarify the existing Hong Kong tax treatment of such instruments and should not seek to disallow deduction claims on coupons of these T2 securities incurred before 1 April 2016.

Appendix A – Our understanding of the Hong Kong profits tax principles in respect of interest expenses incurred by the Hong Kong branches of overseas incorporated financial institutions

Provisions under the Inland Revenue Ordinance ("IRO")

- Under Section 14(1) of the IRO, the following three conditions must be satisfied before a person is liable to Hong Kong profits tax:
  - the person carries on a trade, profession or business in Hong Kong (by himself or through another person);
  - profits are derived from that trade, profession or business; and
  - such profits arise in or are derived from Hong Kong (excluding profits arising from the sale of capital assets).

- A tax deduction is allowed under Section 16(1) to the extent that the expenses are incurred in the production of profits chargeable to profits tax. In addition to section 16(1), the deduction of interest expenses for Hong Kong profits tax is further subject to the specific provisions in Sections 16(1)(a) and 16(2).

- Interest expenses incurred by a bank branch (which is a financial institution under Section 2(1) of the IRO) carrying on a business in Hong Kong and hence chargeable to profits tax pursuant to Section 14 of the IRO, should be deductible under Sections 16(1)(a) and 16(2)(a) of the IRO to the extent that it is not capital in nature. As such, there should be no limitation of a tax deduction for interest incurred by bank branches operating in Hong Kong other than the satisfaction of the abovementioned conditions.

Application of Article 7 of the double tax agreements ("DTAs") entered into by Hong Kong

- While, pursuant to Section 49(1A)(a) of the IRO, the DTAs entered into by Hong Kong with other jurisdictions shall have effect in relation to tax under the IRO "*notwithstanding anything in any enactment*" in Hong Kong, DTAs only allocate taxing rights between contracting states.

- Article 7 of DTAs allocate business profits between contracting states such that where there is a permanent establishment ("PE") in Hong Kong, Hong Kong has the right to tax the profits which are attributable to that PE. The profits that are not attributable to the PE in Hong Kong fall to be taxed under the treaty (at first instance) in the location of the person's residence. Article 7 (or any other Article in a DTA) does not bring the profits to tax in Hong Kong rather this is done through the operation of Hong Kong's domestic law i.e. the IRO.

- Hong Kong's sourced based principles to taxation are different from a residence based system of taxation as enshrined in Hong Kong's DTAs:

  - As per Hong Kong DTAs, where a foreign bank branch carries on business in Hong Kong and derives Hong Kong sourced profits from that business carried on in Hong Kong, Hong Kong has the right to tax the profits under a DTA only to the extent that these profits are attributable to the PE in Hong Kong. In other words, Hong Kong does not have the right to tax Hong Kong sourced profits under the DTA to the extent that they are not attributable to the PE in Hong Kong. These profits are only allowed to be taxed in the hands of Hong Kong's treaty partner so as to avoid double taxation.

  - As per the IRO, where profits are attributable to a PE in Hong Kong under the DTA but are not Hong Kong sourced profits (or deemed to be Hong Kong sourced profits) from banks' business carried on in Hong Kong, they are not subject to tax in Hong Kong pursuant to the IRO. This is because Hong Kong applies a territorial source principle of taxation to determine what is taxable in Hong Kong under the IRO.

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Hong Kong Tax Treatment of Regulatory Capital under the Basel III Framework

Dear Mr. Liu,

Thank you for your e-mail of 4 November 2014 ("**e-mail**") in response to our submission dated 8 August 2014 in relation to the Hong Kong Tax Treatment of Regulatory Capital under the Basel III Framework (the "**First Submission**") as implemented in Hong Kong under the subsidiary legislation of Banking (Capital) Rules (Cap. 155L) ("**BCR**") under the Banking Ordinance (Cap. 155).

As highlighted in the e-mail and during the follow up meeting on 21 November 2014, there are certain specific clarifications that the Financial Services and the Treasury Bureau ("**FSTB**") seeks from the Hong Kong Association of Banks ("**HKAB**") on the First Submission. Below is a summary of HKAB's submissions on the concerns highlighted by the FSTB.

Further, in the paper enclosed (the "**Enclosed Submission**") we have attempted to clarify each of these aspects in greater detail.

Scope of Instruments

With the aim of maintaining a level playing field for banks in Hong Kong in issuing Basel III compliant additional tier 1 ("**AT1**") and tier 2 ("**T2**") instruments and encouraging the bond market development in Hong Kong, we suggest any AT1 and T2 instruments (in forms other than shares) which are recognised by the Hong Kong Monetary Authority ("**HKMA**") or any equivalent regulators and issued in Hong Kong by in-scope financial institutions should be regarded as "debt" with their distributions as "interest" for Hong Kong profits tax purposes ("**Proposed Tax Treatment**").

Scope of Institutions

The recommendation, subject to the Government's policy decision, is for both banks incorporated in Hong Kong and Hong Kong branches of overseas incorporated banks to be 'in-scope' financial institutions.

AT1 and T2 instruments issued by financial institutions which are approved by banking regulators (e.g. HKMA) are different in nature from certain hybrid instruments, albeit of similar features, by non-financial institution corporations. In light of the different regulatory landscape faced by financial institutions and non-financial institution corporate issuers, it is proposed that the Proposed Tax Treatment apply only to in-scope financial institutions which are subject to regulatory capital requirements e.g. the Basel III Framework.

Tax asymmetry issue

In the e-mail, concern around maintaining the symmetry of tax treatment on the distributions from AT1 and T2 instruments between issuers and investors as well as the possibility of tax-driven issuances were highlighted. Due to the territorial source principle of Hong Kong tax regime, distributions claimed as tax deductible by the in-scope financial institutions under the Proposed Tax Treatment should be taxable in the hands of institutional investors to the extent they are considered carrying on a business in Hong Kong pursuant to the Inland Revenue Ordinance ("IRO"). As such, no asymmetrical tax treatment should result from the Proposed Tax Treatment.

Revenue impact assessment

As illustrated in the attached Annex provided by the HKMA and Inland Revenue Department ("**IRD**") at the meeting on 21 November 2014, financial institutions are required to hold a greater level of capital under the Basel III framework. The Basel III framework, as implemented in local law, sets out the minimum recommended regulatory capital required for financial institutions. Banking regulators will agree the actual level of capital required to be held by each in scope financial institution based upon the individual financial institutions' business, its balance sheet and associated risk. This individual capital requirement imposed by the regulator is in most instances greater than the minimum capital required under the Basel III framework.

As the overall capital requirement is incremental from the existing capital held by financial institutions under the current regulatory requirements, any deduction in respect of coupons arising from newly issued AT1 and T2 instruments should not cause any loss to existing revenue. The revenue impact assessment should not only focus on the potential revenue loss from tax deduction, but should also take into consideration additional business growth and tax revenue generated by in-scope financial institutions and peripheral industries from issuance of AT1 and T2 instruments.

Tax driven behavioural change and tax avoidance

The capital form and structure of financial institutions is regulatory driven. From a tax perspective, tax deductions are allowed to the extent that interest expenses are incurred in the production of chargeable profits in Hong Kong and accordingly for the coupons to be deductible the deployment of the funds from any AT1 or T2 must be used to generate Hong Kong chargeable profits.

The pricing for ordinary debt, AT1, T2, and equity issuances differ as the risks associated with holding these instruments differ. It is not economical for banks to issue excessive AT1 or T2 instruments from a purely tax driven motive as illustrated by the numerical example comparing the issuance of ordinary debts and AT1 instruments in the Enclosed Submission. From an investor perspective, AT1 and T2 instruments are viewed as debt instruments differing in forms of return and risk profile from equity instruments. As such, it is unlikely that banks will issue excessive AT1 and T2 instruments to replace common equity just to leverage on the Proposed Tax Treatment.

In any event, the IRD has existing safeguards through (i) the nexus requirement that the issuance must be deployed for the production of Hong Kong assessable profits and/or, (ii) invoking the existing general anti-avoidance provisions where necessary to deal with any (unlikely) issuance of AT1 or T2 instruments for pure tax avoidance. This is similar to the approach adopted by Singapore and the United Kingdom.

Related party issuances

There are other concerns which were brought up by the IRD during the meeting particularly surrounding hybrid tax mismatch on related party issuances between Hong Kong and overseas jurisdictions. Hybrid tax mismatch between jurisdictions is a wider international tax issue which OECD is trying to resolve under BEPS Action 2 and hence is not a specific issue that should be addressed for the current proposal. Reference should be made to Singapore and UK which do not carve out any related party issuances for AT1 and T2. In any case, the recently issued BEPS Action 2 report also recognises that further consideration would need to be given to intra-group regulatory capital issuance.

For Hong Kong profits tax purpose in the context of the current proposal, to the extent that related party issuances are acknowledged by regulatory bodies and are at arm's length, nexus requirement under Section 16(1) and the existing general anti-avoidance provisions of the IRO should provide sufficient safeguard to deal with related party issuances with a view to exploit the tax deductions on distributions.

It is common international practice for global and multinational banking groups to raise capital from the market through a single point of entry and then distribute funds through inter-company financing transactions. Therefore, arm's length related party issuances should not be excluded from the scope of the Proposed Tax Treatment, as it may create different treatment between global and multinational banking groups opting for Hong Kong as the single point of market entry as compared to domestic banking groups.

Tax treatment for Hong Kong branches of foreign banks

During the meeting, the IRD expressed concern over the tax treatment for Hong Kong branches of foreign banks if they are included as in-scope financial institutions for the Proposed Tax Treatment. The inclusion or not is ultimately a government policy decision. We set out below the consequence for non-inclusion and the possible safeguards if included.

If the Proposed Tax Treatment is only applicable to Hong Kong-incorporated banks, any AT1 or T2 instruments issued by these entities will be treated by the IRD as equity for Hong Kong profits tax purposes. This may potentially result in discriminative tax treatment on the same financial instruments issued by Hong Kong-incorporated banks as opposed to non-Hong Kong incorporated banks with branches in Hong Kong which is not in accordance with the generally accepted international tax principles, including the tax treaties entered into by Hong Kong.

As explained under "Related party issuance", the nexus requirement under the current Hong Kong profits tax regime ensures any tax deductible expense/outgoing to be incurred for the production of assessable profits in Hong Kong. The nexus requirement, together with the profit attribution rules in respect of interest-bearing debt under the OECD's Report on Attribution of Profits to Permanent Establishments, should provide sufficient protection against any potential revenue losses through extending the Proposed Tax Treatment to Hong Kong branches of overseas-incorporated banks.

Conclusion

To provide clarity of Hong Kong tax treatment on AT1 and T2 instruments and to put banks in Hong Kong in a comparable position with their counterparts in competing financial centres in the context of regulatory capital issuance, we, again, respectfully seek the FSTB's support to adopt the Proposed Tax Treatment which should be clarificatory in nature.

For a more detailed discussion of the above issues, please refer to the Enclosed Submission.

Should you have any queries, please contact the Secretariat (Ivy Wong at 2521-1169).

Yours sincerely

Eva Wong
Secretary

Enc.

c.c. Inland Revenue Department (Attn: Mr Chiu Kwok-kit)
Hong Kong Monetary Authority (Attn: Ms Karen Kemp)

The Hong Kong Association of Bank's Second Submission to the Financial Services and the Treasury Bureau on Hong Kong Taxation of Instruments Which Qualify as Additional Tier 1 and Tier 2 Capital under the Basel III Framework

Introduction

In response to the specific clarifications that the Financial Services and the Treasury Bureau ("**FSTB**") and the Inland Revenue Department ("**IRD**") seek from the Hong Kong Association of Banks ("**HKAB**") on the our submission dated 8 August 2014 in relation to the Hong Kong Tax Treatment of Regulatory Capital under the Basel III Framework (the "**First Submission**"), we have prepared this paper to facilitate the discussion among policy makers on the proposal of treating Additional Tier 1 ("**AT1**") and Tier 2 ("**T2**") instruments as "debt" and their distributions as "interest" for Hong Kong profits tax purposes ("**Proposed Tax Treatment**").

For ease of reference, the First Submission and tables setting out a high-level summary of the relevant tax treatment (proposed in the case of Singapore) of AT1 and T2 instruments for issuers and investors in Singapore and the United Kingdom (the "**UK**") have been attached as Appendices 1 and 2 respectively.

The scope of the Proposed Tax Treatment

One of the key aspects to be clarified is the scope of the instruments and institutions under the Proposed Tax Treatment. Our response in this regard is highlighted in the sections below.

Scope of instruments

Given the capital framework under the Banking (Capital) Rules (Cap. 155L) ("**BCR**") of the Banking Ordinance (Cap. 155) prescribed by the Hong Kong Monetary Authority ("**HKMA**") for banks in Hong Kong is generally in line with the standard set out in the Basel III framework established by the Basel Committee on Banking Supervision ("**BCBS**"), the Proposed Tax Treatment should cover AT1 and T2 instruments with the following conditions:

- qualify as capital for the purposes of satisfying regulatory requirements under the BCR issued by the HKMA or equivalent regulation drafted based on the Basel III Framework set out by the BCBS;
- issued in the legal form other than shares; and
- issued in Hong Kong by in-scope financial institutions (as defined below).

The Proposed Tax Treatment should also apply to in-scope instruments that are issued in excess of minimum capital adequacy requirements, subject to further limitations discussed under the section "Bond market development".

Scope of institutions

It is our view that the in-scope financial institutions should, at minimum, encompass banks incorporated in Hong Kong. Banks incorporated in Hong Kong have to comply with the provisions of the Banking Ordinance which, among other things, require them to maintain adequate liquidity and capital at or above the minimum requirements for Common Equity Tier 1 ("**CET1**"), AT1 and T2 set out in the BCR and any additional requirements imposed by the HKMA.

Regarding the possibility of including Hong Kong branches of overseas incorporated banks, this is a policy decision to be made by the Government and respectfully leave it for FSTB's further consideration. However, since these branches are subject to the capital requirements in the jurisdictions where their headquarter is located, to the extent that the AT1 and T2 instruments they issue satisfy the first two conditions set out above under the heading "Scope of instruments", we suggest that the FSTB also consider inclusion of these institutions as the in-scope financial institutions for the Proposed Tax Treatment. The IRD's concern in this regard will be addressed under the sub-section "Tax treatment for Hong Kong branches of foreign banks" in this letter.

As regards not extending the Proposed Tax Treatment to ordinary hybrid instruments issued by corporates not being in-scope financial institutions, we submit that the regulatory capital requirements introduced to enhance the resilience and stability of the banking and financial system are specific to in-scope financial institutions only. Hence, AT1 and T2 instruments issued by in-scope financial institutions in line with the relevant regulations should be distinguished from ordinary non-banking regulated hybrid instruments issued by other non-financial institution corporates.

Further, given the nature of business undertaken by in-scope financial institutions and the regulatory framework they operate under, the Inland Revenue Ordinance ("**IRO**") does have specific provisions applicable to financial institutions ("**FIs**")[1] that do not extend more broadly to other taxpayers. For instance, Sections 15(1)(i) and 15(1)(l)[2] on the income side and Section 16(2)(a) (without further subjecting to conditions under Sections 16(2A),(2B) or (2C)) on the expense side. While these examples are non-exhaustive, it is clear that introduction of specific provisions or tax treatment for FIs, is not unprecedented Under the IRO.

The regulations issued in Singapore and the UK for the tax treatment for AT1 and T2 instruments are also specific to regulated or qualifying entities and do not extend beyond the specified scope to hybrid instruments issued by other non-regulated or qualifying entities. It is also acknowledged by the OECD under Action 2 – Neutralise the effects of hybrid mismatch arrangements of its Base Erosion and Profit Shifting Project ("**BEPS**

[1] "Financial institution" is defined under Section 2 of the IRO which means "*(a) an authorised institution within the meaning of section 2 of the Banking Ordinance (Cap 155); (b) any associated corporation of such an authorised institution which, being exempt by virtue of section 3(2)(a) or (b) or (c) of the Banking Ordinance (Cap 155), would have been liable to be authorised as a deposit-taking company or restricted licence bank under that Ordinance had it not been so exempt; (Replaced 27 of 1986 s. 137. Amended 3 of 1990 s. 55; 49 of 1995 s. 53)*"

[2] Section 15(1)(i) applies to "sums... received by or accrued to a financial institution by way of interest" while Section 15(1)(l) applies to "sums... received by or accrued to a financial institution by way of gains or profits arising through or from... the sale or other disposal or on the redemption on maturity or presentment of a certificate of deposit or bill of exchange".

Action 2") that hybrid regulatory capital issued by banks should be distinguished from ordinary hybrid instruments and hence not subject to automatic hybrid rules.

Given the above, as Hong Kong already lags behind other competing jurisdictions to clarifying the tax implications of Basel III regulatory capital instruments, Hong Kong should definitely prioritise providing clarity around the tax implications for these instruments issued by the in-scope financial institutions.

Having defined the scope for the Proposed Tax Treatment, we would also like to address other practical concerns raised by the FSTB and the IRD as follows.

Maintaining tax symmetry

In line with the FSTB and IRD, we agree that there should be symmetry of definition and treatment on the distributions from AT1 and T2 instruments between issuers and investors. Under the Proposed Tax Treatment, where the distributions from in-scope instruments will be deemed as interest arising from debt instruments for profits tax purposes, the tax treatment for both issuers and investors will follow that for interest arising from ordinary debt instruments.

According to the general charging provision in Section 14 of the IRO, interest income arising in or derived from Hong Kong which is derived from a business carried on in Hong Kong is subject to profits tax. Therefore, if distributions from AT1 and T2 instruments are deemed as interest arising from debt instruments, institutional investors (being the target audience of these instruments) which are carrying on business in Hong Kong should be taxed on the distributions from these instruments in Hong Kong.

Due to the territorial nature of the Hong Kong tax regime, investors in AT1 and T2 instruments who do not carry on business in Hong Kong will not be taxable in Hong Kong, but may be taxable in their tax resident jurisdiction, as is the case for non-residents investing in ordinary debt instruments. This is consistent with the approach adopted by Singapore and the UK.

Revenue impact assessment

As illustrated in the Annex provided by the HKMA and IRD, financial institutions are required to hold a greater level of capital under the Basel III framework. The Basel III framework, as implemented in local law, sets out the minimum recommended regulatory capital required for financial institutions. Banking regulators will agree the actual level of capital required to be held by each in-scope financial institution based upon the individual financial institutions' business, its balance sheet and associated risk. This individual capital requirement is in most instances greater than the minimum required under the Basel III framework.

As the overall requirement is incremental, any interest deduction arising from newly issued AT1 and T2 instruments should not cause any loss to existing revenue.

Further, the revenue impact assessment should not only focus on the potential revenue loss on granting a tax deduction on the coupons but should also positively take into account:-

- the additional business growth and taxable revenue generated by the in-scope financial institutions out of the additional funds raised by the newly issued AT1 and T2 instruments as any tax deduction claimed by a financial institution is subject to the its nexus towards generating Hong Kong taxable profits; and
- the additional financial and economic growth to Hong Kong's economy through additional credit availability, the bond market and peripheral industries supporting financial institutions such as securities and valuation agents, the stock exchange, lawyers and accountants etc.

Information on Hong Kong financial institutions' capital plan should be available from the HKMA.

Tax-driven behavioural changes and tax avoidance

Another concern raised was that in-scope financial institutions may possibly exploit the Proposed Tax Treatment by issuing AT1 or T2 instruments with tax deductible distributions instead of CET1 with dividends that are not tax deductible for tax-driven purposes and whether any specific tax avoidance rules are required. We wish to reiterate that, the issuance of AT1 and T2 instruments is driven by genuine regulatory and commercial reasons[3] for in-scope financial institutions and given their distinct features, AT1 and T2 instruments should not be directly compared to CET1.

Regulatory drivers

From a regulatory perspective, banks are required to hold a higher ratio of Tier 1 capital (comprising CET1 and AT1 capital) to their risk-weighted assets ("**RWA**") under Basel III than under Basel II.[4] On top of the increased quantitative requirements for CET1, AT1 and T2, the Banking (Capital) (Amendment) Rules 2014, the Banking (Liquidity) Rules gazetted on 24 October 2014[5] and the Leverage Ratio Framework[6] also introduced a series of capital buffers (i.e. the capital conservation buffer and the countercyclical buffer), a liquidity coverage ratio and a non-risk based leverage ratio[7] which aim at enhancing the quality of capital that banks hold. These are consistent with the phase-in arrangement of the Basel III framework which was covered in our First Submission.[8] In addition to the capital requirement under Pillar I of the Basel III framework, the HKMA will also apply specific Pillar II Capital Add-on requirements to individual banks.

[3] For commercial drivers, please refer to Section 3 of the First Submission.

[4] While the minimum total capital requirement under Basel III remains at 8%, banks are required to maintain a minimum of CET1 capital of 4.5% and Tier 1 capital (comprising CET1 and AT1 capital) of 6%, which represents an increase of 50% of Tier 1 capital requirement. In addition, the more stringent calculation of RWA under Basel III further increases the quantity of Tier 1 capital that banks are required to hold.

[5] http://www.info.gov.hk/gia/general/201410/24/P201410230720.htm

[6] Issued by the HKMA on 9 May 2014 (http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/basel-3/basel-3_implementation_Leverage_Ratio/Annex_to_Leverage_Ratio_Framwork_20140509.pdf)

[7] It is the quotient of Tier 1 capital (comprising CET1 and AT1 capital) divided by exposure measure (including on-balance sheet exposures, derivative exposures, securities financial transaction exposures and off-balance sheet items. Banks in Hong Kong are currently reporting their leverage ratios to the HKMA periodically.

[8] Under Section 3 "Drivers for the issuance of AT1 and T2 capital instruments in Hong Kong".

In view of the increased regulatory capital and buffer requirements on CET1 under the Basel III framework, it is unlikely that banks would be able to exploit the issuance of AT1 and T2 capital to replace CET1 merely for tax purposes. As discussed during the meeting, while banks in Hong Kong generally are well capitalised with Tier 1 capital ratio above the minimum regulatory requirement under Basel II, it will be likely for them to issue additional regulatory capital due to the above regulatory updates.

<u>*Commercial drivers*</u>

Issuance of AT1/T2 instruments instead of CET 1 capital

The drivers for capital issuance and the form thereof are driven by regulatory and commercial considerations. Subject to regulatory rules, commercially, the cost of AT1 or T2 capital is typically lower than CET1 capital, even without the Proposed Tax Treatment of having coupons considered as tax deductible[9]. It is also worthwhile to note that despite the uncertain tax treatment of AT1 and T2 instruments, banks in Hong Kong have already issued or are planning to issue AT1 instruments to comply with the latest regulatory development.[10]

Commercially from investors' perspective, AT1 or T2 instruments issued in form of "debt" are not directly comparable to equity instruments (i.e. CET1) given that the return and risk appetite of debt and equity investors are totally different.

Equity investors are totally different pool of investors from the debt investors. Equity investors look for capital appreciation and variable dividend return. In contrast the return/distribution from AT1 and T2 instruments is predefined and is rather limited as opposed to equity instruments. Further AT1 and T2 instruments are typically traded over-the-counter and inconsistent with the mandate of equity investors investing in listed shares. Therefore, investors in banks' ordinary shares which qualify as CET 1 capital are usually equity investors while investors in AT1 and T2 instruments are mainly fixed income investors.

Since there are different groups of target investors for debt and equity instruments, the chances for the in-scope financial institutions to exploit the Proposed Tax Treatment by issuing AT1 or T2 instruments instead of equity instruments to equity investors are minimal.

Issuance of AT1/T2 instruments instead of vanilla debt instruments

Further, from a commercial perspective, while in-scope financial institutions may organise their capital affairs as efficiently as possible to reduce the after tax cost of capital, it would not make economic or commercial sense to carry more AT1 instruments merely to obtain a tax deduction as opposed to issuing vanilla debt instruments or normal loan financing.

[9] An illustrative example on this point was included in the First Submission as Annex D.
[10] Chong Hing Bank issued US$300 million AT1 instruments on 25 September 2014 (http://www.chbank.com/en/pdf/20140925_news.pdf) and China CITIC Bank International Limited issued US$300 million AT1 instruments on 23 April 2014 (http://www.hkexnews.hk/listedco/listconews/sehk/2014/0422/LTN20140422195.pdf).

Take the issuance of US$800 million vanilla bonds and AT1 instrument as an example:

	Vanilla bonds	**AT1 instrument (coupon is deductible)**
Cost of capital (%)	3.3% p.a.[11]	6.5% p.a.[12]
Cost of capital before tax (USD)	26.40 million	52.00 million
Less: Tax deduction at 16.5% (USD)	(4.36 million)	(8.58 million)
Cost of capital after tax (USD)	22.04 million	43.42 million
After-tax cost of capital (%)	2.76% p.a.	5.43% p.a.

Still 2.67% higher with tax deduction on coupons

Accordingly, the cost of AT1 regulatory capital is sufficiently prohibitive compared to vanilla debt instruments that in-scope financial institutions will not hold additional AT1 capital merely to obtain a tax deduction.

Bond market development

As illustrated in the above example, from a commercial perspective in-scope financial institutions will only issue AT1 and T2 instruments pursuant to the regulatory capital requirements as the funding costs of such instruments are much higher than ordinary debt instruments and hence, it is not cost effective to issue such instruments for purely tax purposes.

In order to promote financial stability in Hong Kong as part of the international measures mandated by FSB and Basel Committee to increase the quantity and quality of banking capital, it is therefore suggested that the Proposed Tax Treatment be extended to AT1 or T2 instruments issued in excess of minimum capital adequacy requirements provided that:

i) they are issued by in-scope financial institutions;
ii) they satisfy the three conditions under "scope of instruments"; and

[11] The figure represents an estimate according to the Average borrowing costs and new issuance size of non-government issuers in Hong Kong dollar bond market in the article "The Hong Kong Debt Market in 2013" issued by the HKMA (http://www.hkma.gov.hk/media/eng/publication-and-research/quarterly-bulletin/qb201403/fa1.pdf)

[12] The figure represents the average coupon rate of the recent AT1 issuance by Chong Hing Bank, ICBC (Asia) Limited and Bank of China in Hong Kong.

iii) the funds are used by the issuers to produce Hong Kong assessable profits and accordingly meet the conditions of Section 16(1) of the IRO for tax deductibility.

A similar approach is adopted by other international financial centres such as Singapore and the UK.

Safeguards against possible tax avoidance scheme

Notwithstanding the genuine regulatory and commercial reasons for in-scope financial institutions to issue AT1 and T2 instruments, we appreciate that there should be safeguards against possible tax avoidance scheme to protect the revenue. We would like to highlight that the existing IRO already provides sufficient safeguards for the IRD to counteract any abusive planning around the Proposed Tax Treatment by in-scope financial institutions.

In addition to the nexus requirements between assessable profits under Section 16(1) of the IRO and the principles for profits attributable to a permanent establishment published by the OECD, the IRO has effective general anti-avoidance rules in Sections 61 and 61A such that in the unlikely event that an instrument is issued as part of an aggressive tax avoidance scheme, the deduction could be denied to the issuer. This is consistent with Singapore and the UK where general anti-avoidance rules in the relevant tax law or similar provisions are employed.[13] While the IRD has the discretion to apply anti-avoidance provisions to counteract the potential tax avoidance behaviour driven by the Proposed Tax Treatment, it is important to HKAB that to the extent an issuance is due to regulatory and commercial reasons and is approved by the HKMA (or the home country regulator in the case of Hong Kong branch of the foreign banks), the anti-avoidance provision should not be invoked.

In view of the above, it does not seem necessary to establish additional safeguards without leveraging on the existing mechanisms, since adopting any such position would defeat the policy objective to conserve a simple and efficient tax environment for the maintenance of Hong Kong as an international financial centre, including the continued development of the bond and capital markets.

Specific concerns of the IRD

Related party issuance

During the meeting, the IRD expressed couple of concerns over the potential tax mismatch on distributions from AT1 or T2 instruments:

- In cases where the Hong Kong issuers treat the distributions as tax deductible, while their overseas group holding companies are not taxed on the distribution in their home country;

[13] In the UK, according to paragraph 6 of The Taxation of Regulatory Capital Securities Regulations 2013 (2013 No. 3209), the concessionary tax treatment in relation to AT1/T2 instruments "*do not apply in the case of a regulatory capital security if there are arrangements the main purpose, or one of the main purposes, of which is to obtain a tax advantage for any person as a result of the application of these Regulations in respect of that security*", where "tax advantage" has the meaning given in section 1139 of Corporate Tax Act 2010. This language is similar to the general anti-avoidance provisions in the broader domestic tax law.

- In cases where the home jurisdiction on certain overseas banks does not allow a tax deduction on distributions of Basel III compliant AT1 or T2 instruments may leverage the Proposed Tax Treatment by making an issuance out of their Hong Kong based entity.

Subject to domestic laws and regulations, it is common international practice for global or multinational banking groups to raise capital from the market through multiple points of entry or single point of entry by making use of a central treasury centre (typically the listing parent holding company) which then provides capital funding to other group banking entities through inter-company capital financing arrangements. This is due to a variety of commercial reasons, including cost efficiency or speed to market due to established note issuing programme, better control or governance of group capital and the desire of certain regulators.

It would create non-level business environment should the tax treatment be different for related party issuance (provided the transaction is arm's length) and public issuance by a Hong Kong in-scope financial institution. The potential hybrid tax mismatch between Hong Kong and the home country of the overseas group company is a wider issue which OECD is seeking to address and is not a specific issue that should be addressed for this particular proposal. In any case, even BEPS Action 2 acknowledges that further consideration should be given to intra-group hybrid regulatory capital issuance on the basis of the widespread recognition of the need for financial institutions to be appropriately capitalised and properly regulated. For instance, UK and Singapore do not carve out related party issuances from the application of the tax concessionary treatment for regulatory capital.

Referencing to the proposed legislation in Singapore, the tax concession in respect of regulatory capital issuance also extends to related party issuances to any subsidiary or any other group entity[14] given they are for the purpose of meeting the capital adequacy ratio requirements on a group level. Excluding related party issuances from the Proposed Tax Treatment would then create a competitive disadvantage to global or multinational banking groups opting Hong Kong as the single point of market entry as compared to domestic banking groups in Hong Kong. This is inconsistent with the objective of maintaining Hong Kong's status as an international financial centre.

Therefore, to the extent that related party issuances are acknowledged by regulatory bodies and at arm's length, nexus requirement under Section 16(1) and the existing general anti-avoidance provisions of the IRO should provide sufficient protection against related party issuances with a view to exploit the tax deductions on distributions and related party issuances should not be precluded from the scope of the Proposed Tax Treatment.

Tax treatment for Hong Kong branches of foreign banks

The inclusion or not of Hong Kong branches of foreign banks in this Proposed Tax Treatment is ultimately a government policy decision. We would mention below the consequence of non-inclusion and the possible safeguards if included.

[14] According to "Accounting Standards" as defined under section 4(1) of the Companies Act (Cap.50) in Singapore.

If the Proposed Tax Treatment is only applicable to Hong Kong-incorporated banks, then it implies such instruments issued by overseas incorporated banks with branches in Hong Kong are treated by the IRD as equity for Hong Kong profits tax purposes. It follows that if banks carrying on business in Hong Kong invest in AT1/T2 instruments issued by overseas incorporated banks, such distributions from overseas equity investment could be regarded offshore sourced "dividend" and not taxable.

Based on generally accepted international tax principles, including the tax treaties entered into by Hong Kong, the taxation of a permanent establishment i.e. in this case, a bank branch of a non-Hong Kong incorporated bank should not be less favourably levied in Hong Kong than the taxation levied on Hong Kong incorporated banks, carrying on the same activities.[15] Therefore, for profits tax purposes, there should be a level playing field for all banks in Hong Kong, including branches of overseas banks and to distinguish tax treatment as regards the same financial instruments issued by Hong Kong-incorporated banks and non-Hong Kong incorporated banks with branches in Hong Kong, will lead to discrimination.

In any case, in order for an expense to be deductible for Hong Kong profits tax purposes, there must be sufficient nexus between the expense/ outgoing and the assessable profits in Hong Kong under Section 16(1) of the IRO, i.e. the expense/ outgoing has to be incurred for the production of assessable profits in Hong Kong. Where the AT1 and T2 instruments are issued in Hong Kong and the funds are not used to produce Hong Kong assessable profits such distributions should not be tax deductible in Hong Kong. Even under the OECD's Report on Attribution of Profits to Permanent Establishments, the OECD lays down a framework for assessing when interest-bearing debt is properly attributable to a branch. This takes into account the functions, assets and risks attributed to the branch.

In light of the above, while granting similar tax treatment for AT1 and T2 instruments (other than shares) issued by non-Hong Kong incorporated banks with branches in Hong Kong, simple rules could be adopted prescribing nexus conditions such as the funds raised need to be put into use in their business in Hong Kong so as to generate profits assessable to tax in Hong Kong.

In addition, as explained above, adopting the Proposed Tax Treatment on AT1 and T2 instruments and the relevant coupon payments for a broader population would further facilitate the development of bond/ debt capital market and economic growth in the related industries such as lawyers, accountants and rating agencies in Hong Kong which is consistent with the policy objective to maintain the status of Hong Kong as an international financial centre.

[15] Refer Article 24(3) of the OECD Model Tax Convention and various tax treaties entered into by Hong Kong on Non-Discrimination e.g. Tax treaty between Hong Kong and the United Kingdom

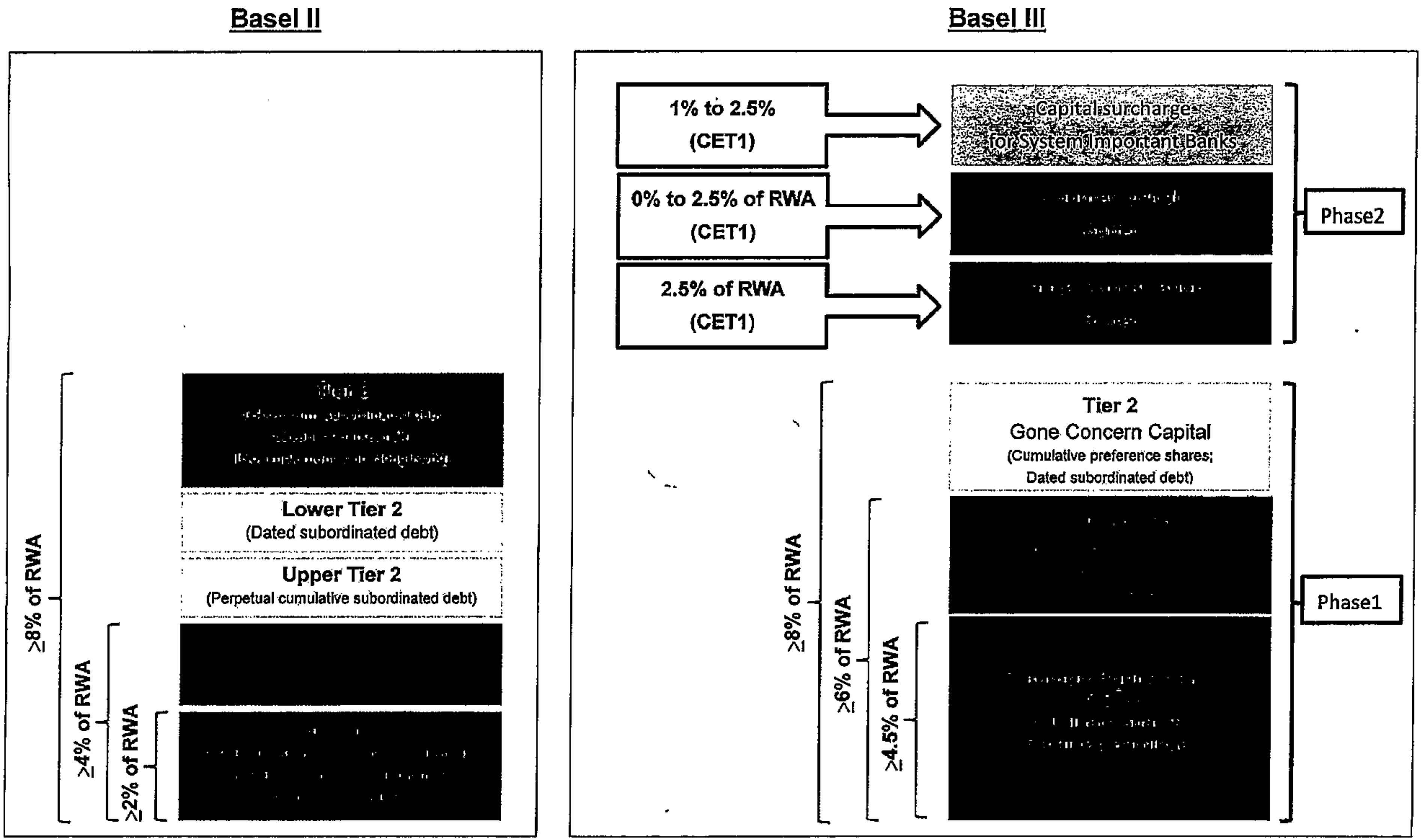
Conclusion

The lack of clarity of Hong Kong tax treatment on AT1 and T2 instruments puts banks in Hong Kong at a competitive disadvantage to their counterparts in comparable international financial centres such as Singapore and the UK.

With genuine regulatory and commercial reasons for banks to issue AT1 and T2 instruments, together with the potential benefits of developing the bond market in Hong Kong, we seek the FSTB's support from a policy perspective to adopt the Proposed Tax Treatment with respect to qualifying AT1 and T2 instruments issued by in-scope institutions under the Basel III framework and the BCR.

Annex

Definition of Capital



Appendix 1

THE
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8 August 2014

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Financial Services and the Treasury Bureau
24/F, Central Government Offices
2 Tim Mei Avenue
Tamar, Hong Kong

Dear Mr Liu

Hong Kong Tax Treatment of Regulatory Capital under the Basel III Framework

We refer to the implementation of the regulatory capital requirements under the Basel III framework in Hong Kong with effect from 1 January 2013. In order to comply with the Basel III capital requirements, it is likely that authorized institutions ("AIs") in Hong Kong would need to issue financial instruments which qualify as Additional Tier 1 ("AT1") and Tier 2 ("T2") capital under the Basel III framework.

The specific features of these financial instruments, in particular AT1 instruments, could give rise to uncertainties and concerns under the existing Hong Kong profits tax and stamp duty laws depending on the interpretation and weighting to be put on these specific features. Such uncertainties if not addressed will result in higher costs of capital for AIs to issue AT1 and T2 instruments in Hong Kong than in other overseas jurisdictions. This will put Hong Kong AIs in a competitive disadvantage position to their counterparts in other competing and comparable international financial centres such as London and Singapore.

With a view to providing clarity and maintaining a level playing field for Hong Kong AIs as well as to promote the development of Hong Kong's bond/ debt capital market, we seek the Financial Services and the Treasury Bureau's support from a policy perspective to enact specific tax legislation with retrospective effect from 1 January 2013 to the Inland Revenue Ordinance (Cap. 112) ("IRO"), the Stamp Duty Ordinance (Cap. 117) ("SDO") with respect to qualifying AT1 and T2 instruments under the Basel III framework:-

THE
HONG KONG
ASSOCIATION
OF
BANKS
香港銀行公會

- AT1 and T2 instruments (other than those in the form of shares) shall be regarded as debt instruments and the coupons shall be regarded as interest for profits tax purposes;

- Any gains on conversion or write down of the principal amount of AT1 and T2 instruments in accordance with the regulatory requirements or the provisions governing the instruments shall be exempt from profits tax; and

- The transfer or sale and purchase of AT1 and T2 instruments shall be exempt from Hong Kong stamp duty.

As Hong Kong already lags behind other competing jurisdictions in clarifying the profits tax and stamp duty implications of Basel III regulatory capital instruments, we respectfully request the enactment of legislative changes to the IRO and the SDO be included in the upcoming 2015/16 budget without further delay. To provide clarity before the completion of the legislation process, we also suggest effective policy guidance be issued to the same effect during the interim period.

Please refer to the enclosed paper for more detailed discussion.

Should you have any queries, please contact the Secretariat (Ivy Wong at 2521-1169).

Yours sincerely

Eva Wong
Secretary

Enc.

cc Inland Revenue Department (Attn: Mr Chiu Kwok-kit)
Hong Kong Monetary Authority (Attn: Ms Karen Kemp)

The Hong Kong Association of Banks' Submission to the Financial Services and the Treasury Bureau on Hong Kong Taxation of Instruments Which Qualify as Additional Tier 1 and Tier 2 Capital under the Basel III Framework

1. Executive summary

Hong Kong authorized institutions are currently at a competitive disadvantage to their counterparts in comparable and competing international financial centres such as London and Singapore because of the lack of clarity and the potential adverse Hong Kong profits tax and stamp duty implications of certain capital instruments under the Basel III framework.

In light of the implementation of the Basel III capital requirements in Hong Kong, authorized institutions in Hong Kong are required to increase the quality and quantity of their capital. Authorized institutions will likely need to raise Additional Tier 1 ("AT1") and Tier 2 ("T2") capital with enhanced loss absorption features to build on the Common Equity Tier 1 ("CET1") capital and replace their existing capital instruments with new Basel III compliant capital instruments.

Comparable international financial centres such as the United Kingdom ("UK") have clarified the tax treatment of financial instruments which qualify as AT1 and T2 capital by way of enacting legislative changes or issuing administrative guidance. AT1 and T2 instruments (other than shares) are regarded as debts and the relevant coupon payments are interest for tax purposes in the UK. Singapore has announced in the Budget 2014 that AT1 instruments (other than shares) issued by Singapore-incorporated banks (excluding their foreign branches) will be treated as debt for Singapore tax purposes and distributions on such instruments will be deductible to issuers. The Monetary Authority of Singapore also issued a circular in line with the proposed measures.

Under the existing Hong Kong tax laws, while both AT1 and T2 instruments issued in the legal form of debt should generally be regarded as debt for profits tax purposes, the tax categorization of AT1 capital instruments is less clear and subject to interpretation. Given AT1 instruments possess both debt and equity features, the categorization of AT1 instruments for profits tax purposes will depend on the weighting to be put on the various debt and equity features of the instruments.

With a view to providing a level playing field for Hong Kong authorized institutions in order to maintain Hong Kong's status as an international financial centre, we seek the Financial Services and the Treasury Bureau's support from a policy perspective to provide clarity of the Hong Kong profits tax and stamp duty treatment of AT1 and T2 capital instruments by implementing legislative changes to the following effect:

- AT1 and T2 instruments (other than those issued in the form of shares) shall be regarded as debt instruments and the coupons shall be regarded as interest for profits tax purposes;
- Any gains on conversion or write down of the principal amount of AT1 and T2 instruments in accordance with the regulatory requirements or the provisions governing the instruments shall be exempt from profits tax; and
- The transfer or sale and purchase of AT1 and T2 instruments shall be exempt from Hong Kong stamp duty.

The above law changes should be enacted without further delay and be included in the upcoming 2015/16 budget. As Hong Kong is lagging behind other competitive jurisdictions, effective policy guidance should also be issued prior to the completion of the legislation process.

Adopting this approach should be revenue neutral for Hong Kong. Authorized institutions, in order to comply with the Basel III capital requirements, are required to hold a greater level of capital (including CET1 capital) both in quantity and quality and accordingly will not be in a position to reduce the existing CET1 capital by issuing AT1 and T2 instruments specifically to enjoy the tax deduction on coupons.

From a wider economic perspective, allowing tax deduction for coupons on these regulatory capital instruments not only reduces the cost of capital for Hong Kong authorized institutions, it also helps to promote the development of Hong Kong bond/ debt capital market and further enhances the stability of the Hong Kong financial system. Improving the stability of the Hong Kong financial system will bring credit to Hong Kong and support the GDP growth.

Given the Basel III capital requirements have been effective since 1 January 2013, we propose the above legislative changes to have retrospective effect from 1 January 2013.

2. Background

The Basel Committee on Banking Supervision published the paper Basel III: A global regulatory framework for more resilient banks and banking systems (revised June 2011) (the "Framework")[1] which introduced new global capital requirements and liquidity standards. The Framework is designed to enhance the resilience of banks and banking systems during periods of economic and financial stress. Among others, the Framework increases the quality and quantity of capital that banks must hold and limits the amount of leverage that banks can take on.

The Framework is implemented in Hong Kong by way of subsidiary legislation under the Banking Ordinance (Cap. 155). For example, the minimum capital requirements and the qualifying criteria of CET1 capital, AT1 capital and T2 capital under the Framework have been incorporated into the Laws of Hong Kong by the Hong Kong Monetary Authority ("HKMA") issuing the Banking (Capital) (Amendment) Rules 2012[2],which revised the Banking (Capital) Rules (Cap. 155L) ("BCR").

We understand that the HKMA is currently working on subsidiary legislation which will implement in Hong Kong the leverage ratio disclosure and the capital conservation buffer in accordance with the Framework in 2015 and 2016, respectively. The Framework is expected to be fully implemented in Hong Kong by 2019.

3. Drivers for the issuance of AT1 and T2 capital instruments in Hong Kong

There are regulatory as well as commercial drivers for the issuance of AT1 and T2 capital instruments in Hong Kong.

From a regulatory perspective, authorized institutions are required to hold a higher ratio of Tier 1 capital (comprising CET1 and AT1 capital) to their risk-weighted assets ("RWA") under Basel III than under Basel II. Under the Basel II requirements, authorized

[1] http://www.bis.org/publ/bcbs189.pdf
[2] http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/basel-3/banking_capital_amendment_rules_2012.pdf

institutions were required to maintain Tier 1 capital of 4% and total capital of 8%. While the minimum total capital requirement under Basel III remains at 8%, authorized institutions s are required to maintain a minimum of CET1 capital of 4.5% and Tier 1 capital (comprising CET1 and AT1 capital) of 6%, which represents an increase of 50% of Tier 1 capital requirement. In addition, the more stringent calculation of RWA under Basel III further increases the quantity of Tier 1 capital that authorized institutions are required to hold. We set out in **Annex A** the minimum capital requirements which are phasing in from 2013 to 2019.

The Framework also introduced the capital conservation buffer and the countercyclical buffer on top of the minimum capital requirements. Both the capital conservation buffer and the countercyclical buffer will be required to be in the form of CET1 capital. Based on the informal discussions between the banking industry and the HKMA, we understand that the HKMA would follow the phase-in arrangement of capital conservation buffer in **Annex A** from a minimum of 0.625% in 2016 to a minimum of 2.5% in 2019. Further, we understand that the HKMA may impose a countercyclical buffer ranging from 0% to 2.5% in line with the Framework[3]. Accordingly, when the Basel III capital requirements are fully implemented in Hong Kong, the minimum CET1 capital requirement (when capital buffers are included) may practically increase from 4% under Basel II[4] to 9.5% of RWA (being the minimum CET1 requirement of 4.5%, the capital conservation buffer of 2.5% and the countercyclical buffer of 2.5%). Moreover, the above minimum CET1 capital requirement has not yet incorporated the higher loss absorption requirements of systemically important financial institutions (SIFIs).

In addition to the risk-based capital requirement, the Framework introduced the non-risk based leverage ratio which is the quotient of Tier 1 capital (comprising CET1 and AT1 capital) divided by exposure measure (including on-balance sheet exposures, derivative exposures, securities financial transaction exposures and off-balance sheet items)[5]. The minimum leverage ratio is 3%. Hong Kong authorized institutions are currently reporting their leverage ratios to the HKMA periodically and will be required to disclosure their leverage ratios publicly starting from 1 January 2015.

In view of the above, while Hong Kong authorized institutions generally are well capitalised with Tier 1 capital ratio above the minimum regulatory requirement, they will likely need to increase their regulatory capital when the Basel III capital requirements are phasing in.

Firstly, from a capital efficiency perspective, the cost of AT1 and T2 capital would typically be lower than the costs of CET1 capital. While the cost of capital could vary quite significantly depending on the credit risk rating of individual authorized institutions, the costs of CET1 capital are generally higher than the coupon rates of AT1 capital instruments, which in turn are generally higher than the coupon rates on T2 capital instruments. An indicative range of the costs of CET1 capital would be from 10% to 15% and the coupon rates of AT1 capital instruments in the market broadly vary from 6% to 8%. Accordingly, authorized institutions would tend to meet the capital requirements by holding certain amounts of AT1 and T2 capital which are cheaper than CET1 capital.

[3] HKMA may impose a countercyclical buffer of more than 2.5% of RWA in extraordinary circumstances.
[4] Under the previous Basel II rules in Hong Kong, there is no differentiation between common equity and Tier 1 capital with both being eligible to be counted as core capital.
[5] Refer to Basel III leverage ratio framework and disclosure requirements (January 2014) which is available on http://www.bis.org/publ/bcbs270.pdf

While the cost of AT1 capital is lower than CET1 capital, the cost of AT1 capital is expensive for authorized institutions to issue a greater amount than required for regulatory purposes taking into account their current and future businesses.

Secondly, the issuance of AT1 and T2 capital instruments would not dilute the shareholders' interest in the authorized institutions until the instruments are converted into the authorized institutions' ordinary shares. Authorized institutions may also eliminate the dilution risk of shareholders' interest by adopting the write-down/ write-off feature of AT1 and T2 capital instruments instead of the conversion feature (refer to the features of AT1 and T2 capital instruments below).

Thirdly, the issuance of AT1 and T2 capital can broaden the authorized institutions' investor base and diversify risks. Generally, investors in authorized institution's ordinary shares which qualify as CET 1 capital are equity investors while investors in AT1 and T2 capital instruments are mainly fixed income investors. Given that the significant increase of CET1 capital requirement from a minimum of 4.5% to potentially 9.5% of RWA creates stress among authorized institutions to raise new capital from equity investors, authorized institutions are keen to broaden their sources of funding, for example, raising funds from fixed income investors to satisfy the capital requirements and sustain the normal banking operations. AT1 and T2 instruments which provide a reliable expected annual return and carry limited risk of principal loss meet the appetite of fixed income investors.

AT1 capital and T2 capital with enhanced loss absorption features have been introduced in accordance with the Framework to improve the stability and resilience of the Hong Kong banking system. Authorized institutions in Hong Kong are required to increase the quality and quantity of capital to support their banking business and limit the amount of leverage that they can take on. Therefore, Hong Kong authorized institutions need to raise AT1 and T2 instruments on top of their existing regulatory capital to replace capital of lower quality (e.g. term notes without the non-viability loss absorption feature). AT1 and T2 instruments cannot replace the existing CET1 capital of authorized institutions even the existing CET1 ratios may exceed the minimum capital requirements under the Framework.

4. Features of regulatory capital instruments under the Framework and BCR

The qualifying criteria of CET1, AT1 and T2 capital are set out in Schedules 4A, 4B and 4C of the BCR, respectively. We summarize below the key features of CET1, AT1 and T2 capital which would have an impact on the respective Hong Kong tax treatment. The main features of AT1 and T2 instruments are also summarised in **Annex B**.

CET1 capital generally comprises ordinary shares, share premium from the issue of ordinary shares and disclosed reserves (i.e. equity), except for reserves specifically excluded under Section 38(2) of the BCR. CET1 capital is the most subordinated interest in an authorized institution for maximum loss absorbency. One of the Basel III criteria is that CET1 capital must be accounted for as equity under the relevant accounting standards.

The qualifying criteria of AT1 capital include:

- The instrument is perpetual and includes no step-ups or other incentives to redeem;
- The instrument may be callable by the issuer only, and that must be after minimum period of 5 years after issue and with prior approval of the HKMA;
- Authorized institutions must not create any expectation at issuance that such a call may be exercised;

- Distributions must be fully discretionary, non-cumulative and can only be paid out of distributable items. The cancellation of distributions does not constitute an event of default for the instrument;
- The instrument is subordinated to depositors, general creditors and subordinated debt of the authorized institution. It is neither secured nor guaranteed to enhance its seniority; and
- The instrument must contain principal-loss absorption features through either conversion to common equity, or a write down mechanism allocating losses to the instrument at the point of non-viability, reducing the claim on such an instrument in liquidation or upon exercise of call option, and the amount of any coupon or dividend.

Where an AT1 capital instrument is classified as a "liability" for accounting purposes, the instrument must be written down or converted to ordinary shares when the authorized institution's CET1 capital ratio falls to a certain level determined by the issuer and specified in the terms and conditions of the instrument (subject to a minimum level of 5.125%).

The key criteria for an instrument to qualify as T2 capital include:

- The instrument has a minimum original maturity of at least 5 years;
- The instrument may be callable by issuer only, and that must be after minimum of 5 years after issue and with prior approval of the HKMA;
- Authorized institutions must not create any expectation at issuance that such a call may be exercised;
- The instrument is subordinated to depositors and general creditors of the authorized institution. It is neither secured nor guaranteed to enhance its seniority; and
- The instrument should be fully and permanently written down or converted fully into CET1 capital at the point of non-viability of the issuer.

Unlike Tier 1 capital, the accounting treatment of T2 instruments is not referred to in the Framework and the BCR.

AT1 and to certain extent T2 instruments are generally hybrid instruments which possess both debt and equity features notwithstanding their legal form may generally be debt. For accounting purposes, the categorization of such instruments as debt or equity often requires a lot of judgement. The market practice in this area is still developing, as more instruments are introduced into the market. Hybrid instruments may be classified as "financial liability" or "equity" depending on the particular terms and conditions. They may also be bifurcated into debt, equity and embedded derivatives for accounting purposes based on the value attributable to each of the components.

5. International landscape

While the Framework and other Basel III requirements provide an international standard framework on banking capital and liquidity requirements, the tax treatment of regulatory capital instruments (especially AT1 capital instruments) varies according to the jurisdictions of the issuers and the jurisdictions of the issuance of the instruments.

International financial centres such as the United Kingdom ("UK") and Singapore have taken proactive steps in addressing the tax implications of regulatory capital under Basel III. For example, the UK have considered the tax treatment of regulatory capital instruments aligned with the broader banking regulatory capital agenda and the desire to increase the banking sector's ability to absorb losses in the event of a financial crisis. The UK has enacted the Taxation of Regulatory Capital Securities Regulations 2013 ("UK Regulations") to confirm that AT1 and T2 instruments are "loan relationships" and the coupon payments are "interest" for corporate income tax purposes. The UK Regulations also exclude any gains or losses arising from the conversion or write down (as well as the subsequent write up of temporary write down) of the principal amount of AT1 and T2 instruments from the calculation of taxable profits of the issuers and the investors. In addition, the transfer of AT1 and T2 instruments is exempt from UK stamp duties under the UK Regulations. While AT1 instruments with certain features and most T2 instruments have been classified as "debt" for UK tax purposes prior to the UK Regulations, the changes to the UK tax laws provided further clarity.

In Asia Pacific, it is stated in the Singapore Budget 2014 ("Budget 2014") that to provide tax certainty and maintain a level playing field for Singapore-incorporated banks, AT1 instruments (other than shares) issued by Singapore-incorporated banks (excluding their foreign branches) will be treated as debt for Singapore tax purposes and distributions on such instruments will be deductible to issuers from the year of assessment 2015. The Monetary Authority of Singapore issued a circular dated 30 May 2014[6] in line with the proposed measures in the Budget 2014. It is expected that there will soon be law changes to implement the proposed tax treatment of AT1 instruments and AT1 coupons in Singapore.

Moreover, recent survey conducted by an industry practitioner (refer to **Annex C**) found that many European nations allow the issuers of AT1 and T2 capital instruments to obtain tax deductions in respect of the AT1 and T2 coupon payments[7].

In summary, two relevant international financial centres, namely the UK and Singapore, generally categorize AT1 instruments (other than shares) as debt and allow tax deductions of the coupons to the issuers. It is also widely accepted in many overseas jurisdictions that T2 instruments are debt instruments and the coupon payments are to be treated as interest for tax purposes. The above treatment lowers the costs of funding and capital which attracts financial institutions to issue Basel III compliant instruments in these jurisdictions and enhances the loss absorption capability of the domestic banking systems. It also provides efficient taxation outcomes for the development of bond/ debt capital markets in these jurisdictions.

6. Hong Kong tax considerations for regulatory capital instruments

There is currently no specific provision in the Inland Revenue Ordinance (Cap. 112) ("IRO") and the Stamp Duty Ordinance (Cap. 117) ("SDO") which deals with the profits tax and stamp duty implications of hybrid financial instruments which possess both the features of debt and equity. Accordingly, the Hong Kong tax and stamp duty implications of instruments which qualify as regulatory capital under the BCR are to be considered under general taxation principles, the application of case law and the administrative practice of the Inland Revenue Department ("IRD").

In broad terms, the three main areas at issue from a Hong Kong tax perspective with respect to financial instruments qualifying as regulatory capital are:

(i) categorization of the instruments and coupon payments for profits tax purposes;

[6] Circular No. FDD Cir 05/2014

[7] http://www.ey.com/Publication/vwLUAssets/EY-global-banking-capital-markets-CRD-IV/$FILE/EY-tax-news-2014061702.pdf

(ii) taxability of gains or deductibility of losses on conversion or write down of the principal amount of the instruments (if any); and
(iii) whether the transfer or sale and purchase of the instruments are subject to Hong Kong stamp duty.

Given the features of CET1 capital, there is consensus among Hong Kong authorized institutions and practitioners that any distributions on CET1 capital instruments should be regarded as dividends which are non-deductible to the issuers and non-taxable to the shareholders for profits tax purposes. Stamp duty should generally apply to the sale and purchase or transfer of CET1 capital instruments (i.e. shares) in accordance with the provisions of the SDO.

T2 instruments issued in the legal form of debt instrument, with fixed maturity and cumulative, non-discretionary coupons should be regarded as debt instruments for profits tax purposes (notwithstanding the loss absorption feature upon non-viability) under the existing provisions of the IRO. Accordingly, taxability of T2 coupons in the hands of the instrument holders and deductibility of the same to the issuers should be determined in accordance with the Hong Kong tax rules applicable to interest income and expenses.

While AT1 instruments are generally also issued in the legal form of debt instruments, their profits tax and stamp duty implications are less clear and subject to interpretation under the existing Hong Kong taxation principles in light of the specific features as required under Basel III. Please refer to the next section for further discussion on the Hong Kong tax implications of AT1 instruments.

We are particularly concerned with the tax deductibility of coupon payments on AT1 instruments as this would have impact on the authorized institutions' costs of capital. If authorized institutions as issuers cannot obtain tax deductions for the coupons, the after-tax cost of capital increases. Taking an AT1 issuance of US$800 million at a coupon rate of 8% per annum as an example, the after-tax cost of capital without a tax deduction for the coupons would be approximately 1.3% per annum higher than the same instrument with a tax deduction for the coupons (based on the current Hong Kong profits tax rate of 16.5%). An illustrative example is enclosed as **Annex D**.

Assuming all other market factors are equal, it will be more expensive for Hong Kong authorized institutions to issue these instruments in Hong Kong than in overseas markets (such as UK and Singapore) where tax deductions are available. Therefore, allowing profits tax deductions on coupons for AT1 instruments is necessary for maintaining a level playing field of Hong Kong authorized institutions vis-à-vis their peers in comparable international financial centres.

7. Hong Kong tax analysis on AT1 instruments

Profits tax

Given that authorized institutions are "financial institutions" under the IRO[8], if the coupons on AT1 instruments are interest for profits tax purposes, they should generally be

[8] "Financial institution" is defined in Section 2 of the IRO to mean:
(a) an authorized institution within the meaning of Section 2 of the Banking Ordinance;
(b) any associated corporation of such an authorized institution which, being exempt by virtue of Section 3(2)(a) or (b) or (c) of the Banking Ordinance, would have been liable to be authorized as a deposit-taking company or restricted licence bank under the Banking Ordinance had it not been so exempt.

In the Banking Ordinance, "authorized institution" is defined to mean:

deductible to the authorized institutions under Sections 16(1)(a) and 16(2)(a) of the IRO to the extent that they are incurred in the production of the authorized institutions' assessable profits.

In practice, the IRD will determine the deductibility of coupon payments with reference to the nature of the instrument. Where the instrument is categorized as debt for tax purposes, the coupon payments will be deductible subject to existing tax rules as set out above. Alternatively, if the instrument is categorized as equity for tax purposes, the distributions will not be deductible as they are an application of profits after derivation rather than outgoings and expenses incurred in the production of assessable profits.

The starting point in analysing the nature of a financial instrument for tax purposes is its legal form. Where the legal rights and obligations created by a financial instrument are not consistent with the purported legal form, the IRD may also consider other factors such as the character of the return (e.g. whether fixed rate return or profit participation), the nature of the holder's interest in the issuer company (e.g. voting rights and rights on winding-up), the existence of a debtor and creditor relationship and the characterisation of the instrument by general law.

Given AT1 instruments generally possess both debt and equity features, the categorization of AT1 capital instruments and the relevant coupons for profits tax purposes will depend on the weighting to be put on various features of the instruments by the IRD.

We submit that under the IRO more weight should be put on the fact that AT1 instruments are generally in the legal form of debt[9], which are issued *bona fide* and in the ordinary course of carrying on business of the issuers in Hong Kong, the instruments constituted the issuers' obligations to repay the investors the principal sum borrowed (albeit subject to the HKMA approval and/ or the happening of contingent events) and coupons are calculated at pre-determined rates by reference to the principal sum borrowed. Other substantive factors, for example, the target investors, the basis of the coupon pricing, the rights of the investors (e.g. no voting rights or participation in equity upside and downside) should also be considered.

Conversely, less weight should be put on features of AT1 instruments for prudential banking regulatory purposes (e.g. perpetuity of the instruments, issuers' discretion to cancel coupon distributions, loss absorption upon non-viability) which have low possibilities of happening.

Under the current law, certain AT1 instruments should be debt for tax purposes and accordingly the coupons should be deductible, provided the above approach is adopted. It is however uncertain as to whether such approach would be adopted by the IRD.

The categorization of AT1 instruments as debt or equity instruments is also relevant in determining the taxability of gains or deductibility of losses on conversion or write down of AT1 instruments for the issuers. Any gains/ losses derived by the issuers from the conversion or write down of equity instruments would be deemed to be capital in nature and therefore non-taxable/ non-deductible. The taxability of gains/ deductibility of losses arising from the conversion or write down of debt instruments is less clear because, notwithstanding that debt instruments would normally be presumed to be the authorized institutions' trading assets or liabilities, AT1 instruments indeed form part of the longer-

(a) a bank;
(b) a restricted licence bank; or
(c) a deposit-taking company.

[9] As observed from the issuances to date in Australia, the United Kingdom and other European countries.

term capital of the authorized institutions and the conversion or write down of the instruments are due to contingent events or regulatory requirements out of the control of the issuers.

The tax categorization of AT1 instruments is less relevant for investors because the taxability of gains or deductibility of losses on conversion or write down of such instruments would generally depend on whether the investors carry on business in Hong Kong and if so, hold the AT1 instruments on capital or trading account.

Stamp duty

Under the SDO, the sale and purchase or transfer of foreign currency denominated AT1 instruments (except to the extent that they are redeemable in Hong Kong dollars) should not come within the definition of "Hong Kong stock" and accordingly should not be subject to stamp duty. However, for AT1 instruments denominated in Hong Kong dollars, as the coupon rates of AT1 instruments may be higher than debt instruments with no loss-absorption features, the coupons are contingent on the issuers having distributable items and the AT1 instruments may be convertible into the issuers' ordinary shares, it is uncertain whether they are "loan capital" which is being excluded from the definition of "Hong Kong stock" in the SDO.

8. Policy recommendations

The lack of clarity and the potential categorization of AT1 instruments as equity for tax purposes in Hong Kong puts Hong Kong authorized institutions at a competitive disadvantage to their counterparts in competing and comparable international financial centres (such as UK and Singapore). This is inconsistent with the Basic Law to maintain the status of Hong Kong as an international financial centre and a policy objective to maintain a level playing field for Hong Kong authorized institutions.

Allowing tax deductions to coupons of AT1 instruments (other than shares) to the issuers is important in providing clarity and a level playing field for Hong Kong authorized institutions vis-à-vis their peers incorporated in overseas jurisdictions.

While T2 instruments (other than shares) should be regarded as debt instruments and hence the coupon payments are interest for profits tax purposes under the existing provisions of the IRO, the Hong Kong tax treatment of T2 instruments and the relevant coupons should also be covered by the proposed legislative changes to the IRO and the SDO for the sake of clarity and further certainty.

In light of the above, we seek the Financial Services and the Treasury Bureau's support from a policy perspective to make the required changes to the IRO, the SDO and the administrative practices with respect to qualifying AT1 and T2 instruments under the Basel III framework and the BCR. Specifically, we propose the following Hong Kong profits tax and stamp duty treatment, which are similar to the UK Regulations, to be implemented by way of legislation:

- AT1 and T2 instruments (other than those in the form of share) shall be regarded as debt instruments and the coupons shall be regarded as interest for profits tax purposes;
- Any gains on conversion or write down of the principal amount of AT1 and T2 instruments in accordance with the regulatory requirements or the provisions governing the instruments shall be exempt from profits tax; and

- The transfer or sale and purchase of AT1 and T2 instruments shall be exempt from Hong Kong stamp duty.

As Hong Kong is lagging behind competing jurisdictions in clarifying the tax and stamp duty implications of Basel III regulatory capital instruments, we respectfully request the Government of the Hong Kong Special Administrative Region to enact the changes to the IRO and the SDO without further delay and include the legislative changes in the upcoming 2015/16 budget.

In the interest of time, we also suggest the Government and/ or the respective Government departments clarify the Hong Kong profits tax and stamp duty treatment of AT1 and T2 instruments by issuing effective policy guidance prior to the completion of the legislation process.

Given the Basel III capital requirements have been effective since 1 January 2013, we propose the legislative changes to the IRO and the SDO to have retrospective effect from 1 January 2013.

Adopting the above tax treatment on AT1 and T2 instruments and the relevant coupon payments would also facilitate the development of bond/ debt capital market in Hong Kong which is consistent with the policy objective to maintain the status of Hong Kong as an international financial centre. Currently, Basel III compliant AT1 and T2 instruments are commonly issued and listed in Singapore, London, Luxembourg, etc. Disallowing the Hong Kong profits tax deductions of coupons on these instruments to the issuers would further reinforce Hong Kong comparative disadvantage against other international financial centres and hinder the development of bond/ debt capital market in Hong Kong.

The debt issuance by authorized institutions is related to the cost of funding. According to an article published by the Monetary Management Department of the HKMA, the amount of debt securities issued by authorized institution issuers dropped nearly 25% in 2013 because the increasing yield posed difficulty for authorized institutions raising debt securities within their target funding level[10].

We believe that allowing profits tax deductions of coupons on AT1 and T2 capital instruments to the issuers could benefit Hong Kong in the following ways:

- increase in investment options for funds and investors in Hong Kong (e.g. investment managers whose mandates focus primarily on Asian fixed income products);
- increase in sophistication of Hong Kong bond/ debt capital market as compared to competing locations such as London and Singapore; and
- increase in business opportunities for industry practitioners, professionals (e.g. lawyers and accountants), rating agencies, etc. associated with the development of bond/ debt capital market in Hong Kong.

As abovementioned, AT1 and T2 capital instruments are raised by Hong Kong authorized institutions to improve the quality and quantity of capital that authorized institutions must hold under the Framework and the BCR. Hong Kong authorized institutions issue AT1 and T2 capital instruments on top of their existing regulatory capital to replace capital of lower quality (e.g. senior term notes without the non-viability loss absorption feature).

[10] The Hong Kong debt market in 2013, Hong Kong Monetary Authority Quarterly Bulletin March 2014 (See http://www.hkma.gov.hk/media/eng/publication-and-research/quarterly-bulletin/qb201403/fa1.pdf)

AT1 and T2 capital instruments cannot replace the existing CET1 capital of authorized institutions.

As the existing capital (other than shares) of Hong Kong authorized institutions are generally debts and authorized institutions are allowed to claim tax deduction in respect of the interest expenses paid on the debt capital, allowing tax deduction of AT1 and T2 coupon payments should not lead to any revenue loss to the Government. Furthermore, in order to meet the full Basel III capital requirements including capital buffers, the level of CET1 capital will be increased and accordingly Hong Kong authorized institutions will not be in a position to reduce the existing CET1 capital by issuing AT1 and T2 instruments specifically to enjoy the tax deduction on coupons.

The Hong Kong Association of Banks
8 August 2014

Annex A

Phase-in arrangements of Basel III regulatory capital requirements

	Basel II	Basel III						
		2013	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Minimum common equity capital ratio	2.0%	3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital conservation buffer	N/A	Nil	Nil	Nil	0.625%	1.25%	1.875%	2.5%
Minimum common equity plus capital conservation buffer	2.0%	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for deferred tax assets, mortgage servicing rights and financials)	N/A	Nil	20.0%	40.0%	60.0%	80.0%	100.0%	100.0%
Minimum Tier 1 capital	4.0%	4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum total capital	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum total capital plus conservation buffer	8.0%	8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital	N/A	Phased out over 10 years horizon beginning 2013						

Annex B

Main features of Additional Tier 1 and Tier 2 capital under Basel III

Main feature	AT1 capital	T2 capital
Maturity	— Perpetual (i.e. no fixed maturity date) — No step-ups or other incentives to redeem	— Can have a fixed maturity of at least 5 years — No step-ups or other incentives to redeem
Repayment	— Repayment of principal must be with regulatory approval — Investor has no rights to demand repayment except in bankruptcy and liquidation	— Investor has no rights to accelerate repayment except in bankruptcy and liquidation
Issuer's call option	— Callable after 5 years with regulatory approval	— Callable after 5 years with regulatory approval
Distributions	— Paid only out of distributable items — Can be cancelled at the bank's full discretion (not an event of default) on a non-cumulative basis — Cannot be based on the banks' credit standing	— Cannot be based on the bank's credit standing — Can be cumulative
Subordination	— Subordinated to depositors, general creditors and subordinated debt of the bank	— Subordinated to depositors and general creditors of the bank
Security and guarantee	— Neither secured nor guaranteed to enhance the seniority of the claim	— Neither secured nor guaranteed to enhance the seniority of the claim
Loss absorption upon non-viability (PONV)	— Local legislation or the terms and conditions of the instrument may provide for converting the instrument into ordinary shares or having the principal amount written down	— Local legislation or the terms and conditions of the instrument may provide for converting the instrument into ordinary shares or having the principal amount written down
Loss absorption upon pre-specified trigger events	— If the instrument is classified as a liability for accounting purposes, the instrument must be converted into ordinary shares or written down when the bank's CET1 capital ratio falls to a certain level with the effects of reducing the claim of the instrument in liquidation; reducing the amount repaid when a call is exercised; and partially or fully reducing the distribution payments on the instrument	— Not applicable

Annex C

International landscape

The following tables are extracted from "CRD IV - Tax treatment of regulatory capital instruments" published by EYGM Limited in May 2014. A full copy of the publication is available on: http://www.ey.com/Publication/vwLUAssets/EY-global-banking-capital-markets-CRD-IV/$FILE/EY-tax-news-2014061702.pdf

Please note that the tables and the information herein are for general reference purposes only. They are not intended to be relied upon as tax or professional advice. Please refer to professional advisors for specific advice where appropriate.

Additional Tier 1 capital

Country	Deductibility of coupon for tax purposes	Withholding tax	Tax on issuance or transfer	Tax charge on trigger events: Write-down	Tax charge on trigger events: Conversion
United Kingdom	Yes	No	No	No	No
Belgium	Yes	No	No *	Yes	No
France	Yes	No	No	Yes	No
Germany	Yes *	No *	No	Yes *	Yes *
Ireland	No	No	No	No	No
Italy	Yes	No	No	No *	No *
Portugal	Yes	No *	No	Yes	No
Spain	Yes	No *	No	Yes	No
Sweden	*	No	No	*	*
Switzerland	Yes	No *	No *	Yes	No
The Netherlands	Yes *	No	No	Yes	No

* There remain uncertainties in respect of the relevant tax treatment.

Tier 2 capital

Country	Deductibility of coupon for tax purposes	Withholding tax	Tax on issuance or transfer	Tax charge on trigger events	
				Write-down	Conversion
United Kingdom	Yes	No	No	No	No
Belgium	Yes	No	No *	Yes	No
France	Yes	No	No	Yes	No
Germany	Yes	No	No	Yes *	No
Ireland	Yes	No	No	No	No
Italy	Yes	No	No	No	No
Portugal	Yes	No *	No	Yes	No
Spain	Yes	No *	No	Yes	No
Sweden	*	No	No	*	*
Switzerland	Yes	No *	No *	Yes	No
The Netherlands	Yes	No	No	Yes	No

* There remain uncertainties in respect of the relevant tax treatment.

Annex D

Illustrative example of tax effect on cost of capital

Take an issuance of US$800 million Additional Tier 1 ("AT1") instrument as example:

	Ordinary shares	**AT1 instrument (coupon is non-deductible)**	**AT1 instrument (coupon is deductible)**
Cost of capital (%)	10% p.a.	8% p.a.	8% p.a.
Cost of capital before tax (USD)	80 million	64 million	64 million
Less: Tax deduction at 16.5% (USD)	-	-	(10.6 million)
Cost of capital after tax (USD)	80 million	64 million	53.4 million
After-tax cost of capital (%)	10% p.a.	8% p.a.	6.7% p.a.

1.3% higher without tax deduction on coupons

Appendix 2A - High-level summary of relevant tax treatment of the UK and Singapore tax treatment on AT1/T2 instruments for issuers

Particulars	United Kingdom	Singapore
1. Scope of instruments	- Regulatory capital securities ("RCS") other than shares which qualify as AT1 and T2 under the Commission Regulation (EU) No 575/2013(b)	- AT1 instruments prescribed in MAS Notice 637 which are issued in Singapore to satisfy the capital adequacy requirements of banks under the Banking Act (Cap. 19) or other financial institutions under the Monetary Authority Action (Cap. 186), even if issued in excess of minimum capital adequacy requirements[1]
2. Scope of entities	- UK incorporated banks; or - UK branches of banks incorporated outside the UK; or - UK incorporated building societies; or - Other designated investment firms	- Specified financial institutions which include: - Singapore-incorporated bank with a full banking licence (excluding its foreign branches); or - Any financial holding company approved as a financial institution under the Monetary Authority of Singapore Act and is a holding company of a Singapore-incorporated bank with a full banking licence; or - A financial holding company designated under the Financial Holding Companies Act and is a holding company of a Singapore-incorporated bank with a full banking licence - For issuance to comply with capital adequacy ratio requirements on a

[1] Under existing tax rules, Tier 2 instruments (other than shares) are regarded as debt for tax purposes.

		group level, also includes any subsidiary or any other group entity[2] and special purpose vehicles[3]
3. Corporate tax treatment	- RCS is treated as a loan relationship. - Broadly, distributions of RCS should be treated as interest and be tax deductible for issuers.	- Subject to existing tax rules and tax concessions (e.g. QDS), distributions made or liable to be made on AT 1 instruments will be tax deductible for issuers.
4. Stamp duty implication	- A transfer of a RCS is exempt from all stamp duties	- Not specified
5. Anti-avoidance provisions	- Specific rule applicable to RCS which is similar to the general anti-avoidance provision in section 1139 of Corporate Tax Act 2010	- While not specifically mentioned in the proposed draft legislation, reliance should be place on the general anti-avoidance provision in section 33 of the Singapore Income Tax Act (Cap. 134)

[2] According to "Accounting Standards" as defined under section 4(1) of the Companies Act (Cap.50) in Singapore.

[3] Given the proceeds from the issuance are immediately available without limitation to an operating entity or holding company in the consolidated group of the entity in a form which meets or exceeds all of the other criteria for inclusion in AT1 capital.

Appendix 2B - High-level summary of relevant tax treatment of the UK and Singapore tax treatment on AT1/T2 instruments for investors

Particulars	United Kingdom	Singapore
Tax on distributions	- For UK tax residents, taxable as income from investment in debt securities - For non-UK tax residents, not taxable	- Subject to existing tax rules and tax concessions (e.g. QDS), distributions made or liable to be made on AT 1 instruments will be taxable in the hands of investors
Tax on capital gains (on disposal /conversion to shares)	- Not taxable	- Not taxable.

Appendix B – Current market and regulatory requirements in respect of regulatory capital securities ("RCSs") to be qualified as Additional Tier 1 ("AT 1") and Tier 2 ("T2") instruments under the Banking (Capital) Rules ("BCR") or other equivalent laws or regulatory requirements

Right to convert into Common Equity Tier 1 capital instruments

With respect to AT1 and AT2 instruments that comply with the qualifying criteria stated in Schedules 4B and 4C of the BCR, it is required under Section 1(e) of both Schedules that where there is a call option, such option may only be exercised after 5 years under certain specific scenarios which are not in control of the issuer[1].

In addition, as recognized in the Second Consultation Paper of "An Effective Resolution Regime for Financial Institutions in Hong Kong" which is jointly published by the Financial Services and Treasury Bureau ("FSTB"), the Hong Kong Monetary Authority, the Securities and Futures Commission and the Insurance Authority, it has been mentioned that upon the execution of a bail-in of a FI as requested by a resolution authority, to absorb losses and recapitalize the financial institution ("FI") to a level capable of restoring market confidence, the resolution authority can demand a write down of RCSs issued by that FI or conversion of such RCSs into Common Equity Tier 1 capital instruments ("CET1").

Issuer's discretion on distribution/ Redemption payment

For instruments to be qualified as AT1 under the BCR, it is required under Sections 1(h) and (g) of Schedule 4B of the BCR that "*dividends or coupons are only paid out of distributable items*" and that issuers of AT1 instruments are required to have the "*full discretion to cancel the distributions*"[2]. It is also a requirement under Section 297(1) of the Companies Ordinance (Cap. 622) that "*a company may only make a distribution out of profits available for distributions*"[3].

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[1] The scenarios include (i) the issuer must have the prior consent of the HKMA; (ii) the issuer has done nothing to create an expectation at issuance that the option will be exercised; and (iii) the issuer cannot exercise, unless the issuer (a) replaces the instrument with the same or better quality capital or (b) demonstrates capital position well above the minimum standards and will remain well above after exercise.

[2] As provided under Schedule 4B of the BCR:"*(1)(g) the dividend or coupon distributions in respect of the instrument are subject to the following— (i) the institution has full discretion at all times to cancel the distributions on the instrument for an unlimited period and on a non-cumulative basis; (ii) the institution has full access to cancelled payments to meet its obligations as they fall due; (iii) the cancellation of distributions on the instrument does not constitute an event of default for the instrument; (iv) the cancellation of distributions on the instrument imposes no restrictions on the institution except in relation to distributions to ordinary shareholders;*
(h) dividends or coupons are paid only out of distributable items"

[3] "A company's profits available for distribution" is further defined under Section 297(2) of the Companies Ordinance as the company's "*accumulated, realized profits, so far as not previously utilized by distribution or capitalization, less its accumulated, realized losses, so far as not previously written off in a reduction or reorganization of capital*".

Appendix C – Discussion on the proposed Section 17G and Section 17H of the Inland Revenue (Amendment) (No. 4) Bill on the Tax Treatment of Regulatory Capital Securities under the Basel III Framework ("the Bill")

The Bill introduced on 4 December in the Legislative Council in Hong Kong contains specific provisions Section 17G and Section 17H, which if enacted will operate to determine the profits chargeable to tax of non-residents carrying on business in Hong Kong. This will result in a different basis of taxation for non-residents and Hong Kong residents and it is a move away on the territorial basis of taxation that has operated in Hong Kong since the enactment of the Inland Revenue Ordinance ("IRO").

<u>Tax treatment under the proposed Section 17G</u>

Section 17G(1) will apply in ascertaining profits in respect of which a non-resident financial institution ("FI") with capital raised through the issue of a regulatory capital security is chargeable to tax in relation to its Hong Kong branch.

Section 17G(2) to 17G(3) seek to treat the Hong Kong branch of the non-resident FI as a distinct and separate enterprise in ascertaining its taxable profits in Hong Kong. In doing so, the language of the proposed Section 17G suggests an approach similar to the authorized OECD approach ("AOA") in attributing profits to permanent establishments ("PEs") including branches. The AOA hypothesizes that the PE is a separate and distinct legal entity from its head office, as in the case of a parent/ subsidiary relationship. Based on this hypothesis transfer pricing rules can then be applied to the PE based on the functions performed, assets used and risk assumed.

<u>Tax treatment under the proposed Section 17H</u>

Section 17H in the Bill as currently drafted can possibly be interpreted as codifying the AOA approach and transfer pricing legislation into the IRO and extend the application to all non-FI and non-RCS issuing taxpayers in Hong Kong which is clearly outside the intended purposes of the current Bill.

<u>Our views on the introduction of the proposed Section 17G and Section 17H into the IRO</u>

The proposed Section 17G and Section 17H in the Bill is a significant change in the manner in which Hong Kong determines the taxable profits of taxpayers in Hong Kong. The introduction of similar language used in Article 7 of the Model Tax Convention on Income and on Capital published by the OECD ("OECD Model Tax Convention"), is a move away from Hong Kong's current territorial source principles (as governed by the general charging section, Section 14 of the IRO). Sections 17G and 17H introduce a different approach to determine the profits chargeable to tax in Hong Kong based on the AOA consistent with Hong Kong's double tax agreements ("DTAs"). In order to articulate why this is a material change we have set out below and explanation of the interaction between the IRO and Hong Kong's DTAs.

1. Hong Kong's DTAs allocate taxing rights between Hong Kong and its treaty partner but they do not confer any additional powers to the Inland Revenue Department ("IRD") to assess a taxpayer to the extent that the IRO does not itself impose taxation.

2. Under Section 14 of the IRO, a person (including a corporation) will be subject to profits tax in Hong Kong if the person:
   a. carries on a trade, profession or business in Hong Kong;
   b. derives profits from that trade, profession or business, other than profits from the sale of capital assets; and
   c. those profits arise in or are derived from Hong Kong (i.e. the profits have a Hong Kong source).

3. The concept of the attribution of profits to a PE under Article 7 of Hong Kong's DTAs is fundamentally different from the basis in which Hong Kong taxes non-residents carrying on business in Hong Kong with respect to profits that are sourced in Hong Kong. In other words Hong Kong sourced profits does not equate to the attributable profits of a PE in Hong Kong.

<u>The relationship between DTAs and domestic tax law</u>

Section 49 of the IRO provides that Hong Kong's DTAs apply "*notwithstanding any other enactment*", however, Section 49(1) also states that Hong Kong enters into DTAs *inter alia* to afford relief from double taxation in relation to income tax. As a result, while DTAs should apply "*notwithstanding any other enactment*", they only allocate taxing rights by limiting the application of the existing domestic tax law but do not create new domestic taxing rights.

Hong Kong's DTAs provide relief on double taxation and do not confer any additional power to assess a taxpayer on the IRD to the extent that the IRO does not itself impose such taxation. This is an established principle in the relationship between DTAs and the domestic tax law of the parties to the DTA. A DTA neither generates a tax claim that does not otherwise exist under the domestic tax law nor does a DTA expand the scope or alters the type of an existing tax claim of the parties to the DTA. This principle has been referred to on page 27 of *Klaus Vogel on Double Taxation Conventions* and has been held by various courts in their judgments on international tax matters[1]. This view is also supported in the Australian case in *Roche Products Pty Ltd v. Commissioner of Taxation* 70 ATR 703 wherein it is stated that,

[1] In the German court case, OstVwGH 45 OStZB 127 (1992), it is stated that "*the extent to which a State levies taxes within the boundaries drawn by DTAs is determined exclusively by its own domestic law*". According to the Swiss Constitutional law, DTAs may neither create nor increase tax liabilities, as under the Swiss Federal Constitution DTAs are not subject to a referendum (*Locher, P., supra*, at 368), the only means allowable for the imposition of taxes in Switzerland. According to Art. I, Sect. 7, Cl. 1 of the US Constitution, all laws which relate to the imposition of tax liability "shall originate" in the House of Representatives (*Shannon, H.A.,* Doppelbesteuerungsabkommen, *supra* m.no. 15, at 100). The same principle also applies in the UK as a consequence of the Queen's authorization to enact a tax treaty though an "Order in Council" only for the purpose of "*affording relief from double taxation*" (*Baker, P. supra* m.no. 1, at 9).

"I note that there is a lot to be said for the proposition that the treaties, even as enacted as part of the law of Australia, do not go past authorizing legislation and do not confer power on the Commissioner to assess. They allocate taxing power between the treaty parties rather than conferring any power to assess on the assessing body".

Imposition of taxation for non-residents in Hong Kong

Under Hong Kong domestic law, Section 14 of the IRO is the general charging provision which lays down the basis for taxation in Hong Kong. This Section states that a person (including a corporation) will be subject to profits tax in Hong Kong if the person:

- carries on a trade, profession or business in Hong Kong;
- derives profits from that trade, profession or business, other than profits from the sale of capital assets; and
- those profits arise in or are derived from Hong Kong (i.e. the profits have a Hong Kong source).

A branch office of an overseas company does not legally have a separate legal persona from the overseas head office. However, Rule 3 of the Inland Revenue Rules ("IRR") sets out, for practical reasons, the 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. Rule 3(2) of the IRR provides that where any accounts prepared by a bank for its own purposes disclose, in the opinion of the IRD, the true profits of the Hong Kong branch, the assessable profits shall be computed on the basis of such accounts.

Other than the above method for ascertainment of assessable profits as required under Rule 3 of the IRR, there is no distinction currently made between residents and non-residents in determining the scope of charge of profits chargeable to tax pursuant to Section 14 of the IRO. A resident may therefore derive profits from abroad without suffering tax; conversely, a non-resident may only be subject to profits tax in Hong Kong to the extent it derives profits which are Hong Kong sourced as per Section 14 of the IRO (except for profits deemed chargeable under certain specific provisions).

In determining the source of profits for the purposes of the IRO, the broad guiding principle laid down in *CIR v Hang Seng Bank Ltd* [1991] 1 AC 306 by the Privy Council is that "*one looks to see what the taxpayer has done to earn the profits in question and where he has done it*". In *Kwong Mile Services Ltd v CIR* the court noted the absence of a universal test but emphasized, "*the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters*". The focus is therefore on establishing the geographical location of the profit producing transactions themselves as distinct from activities antecedent or incidental to those transactions. In *ING Baring Securities (Hong Kong) Ltd v CIR,* it was stated that "*such antecedent activities will often be commercially essential to the operations and the* *profitability of the taxpayers business, but they do not provide the legal test for ascertaining the geographical source of profits...".*

Profits of a non-resident's Hong Kong branch properly assessed under Section 14 of the IRO as profits arising in or derived from Hong Kong might be regarded by another DTA state as profits sourced within its jurisdiction under the DTA. Where juridical double taxation is suffered by a Hong Kong enterprise arising from the application of the domestic tax law of the source DTA state, the Business Profits Article and the Methods for Elimination of Double Taxation Article, which are modeled on Article 7 and Article 23 respectively of the OECD Model Tax Convention, in each of the DTAs of Hong Kong provide for both primary profit reallocation adjustments and relief from the resultant juridical double taxation[2]. Hence, the proper application of Articles 7 and 23 of the DTAs entered into by Hong Kong should only result in relief of double taxation to the extent that appropriate amounts of profits have been attributed to the PE as ascertained under the principles stated in Article 7 of the DTAs, subject to the scope of charge as ring fenced under Section 14 of the IRO.

The AOA Approach

The current version of the AOA was introduced in July 2010 when the OECD approved the then new Article 7 (Business Profits) and Commentary for the OECD Model Tax Convention, which incorporated a new authorized approach to the attribution of profits to PEs (of which the most common example are branches). The principles of the AOA were then published in the 2010 Report on the Attribution of Profits to Permanent Establishments ("2010 OECD PE Report") on 22 July 2010. According to the 2010 OECD PE Report, the basis for the development of the AOA was to examine how the approach of treating a PE as a hypothetical separate and independent enterprise could be applied to attribute profits to that PE of a banking, global trading or insurance enterprise in accordance with the arm's length principle of Article 7[3].

In accordance with Article 7, the AOA applies the arm's length principle relevant to separate but associated enterprises to determine the amounts attributable to a PE in its dealings with the rest of the enterprise of which it is a part. To do this, the AOA takes a two-step approach. It first hypothesizes the PE as a separate enterprise engaged in the same or similar activities under the same or similar conditions, taking into account functions performed, assets used and risks assumed by the PE. In applying the functionally separate entity approach to a PE, the AOA focuses on what the PE actually does (that is the functions performed by the branch). This then determines the assets that the PE 'owns' (assets follows function principle) and the risks that the PE assumes (risks follows functions principle).

[2] Paragraph 6, Departmental Interpretation and Practice Notes No. 45.

[3] Article 7 of the OECD Model Tax Convention clearly hypothesizes the PE as a separate enterprise from the enterprise of which it is a part and applies usual transfer pricing principles, subject to the required functional analysis determining the recognition of relevant 'dealings' between the PE and the enterprise's other operations. The Article 7 Commentary recognizes economic differences between PEs and subsidiaries and the Article is not intended to achieve equality between PEs and subsidiaries in all respects.

As the second step, the dealings arising from the functions, assets and risks attributable to the PE are then priced as if the PE were a separate and independent enterprise dealing at arm's length with the rest of the enterprise — that is, the price 'charged' for the dealing is commensurate with what an independent party dealing at arm's length would charge.

Difference between the existing application of Article 7 of the DTAs and the proposed Section 17G

The concept of the attribution of profits to a PE under Section 17G is fundamentally different from the approach under the IRO. While there is a significant overlap between what may be Hong Kong sourced profits and profits attributable to a permanent establishment in Hong Kong Hong Kong sourced profits does not equate to the attributable profits of a PE in Hong Kong.

This distinction has been explained below:

- The territorial source principle which is currently adopted in Hong Kong is the principle for the taxation by a territory of the income derived from sources located in that territory. This means that regardless of the residence of the taxpayer, a jurisdiction may consider certain income as taxable when such income arises within its jurisdiction (i.e. residents and non-residents may be taxed). Source principle thus requires one to determine the source of business income by analyzing the facts and circumstances (i.e. what the taxpayer has done to earn the profits in question) at a transaction level. Under the territorial source principle, a Hong Kong branch of non-resident FI is only taxable for its branch profits to the extent these profits were derived from Hong Kong.

- The AOA, as enshrined in Article 7 of the DTAs, requires taxable profits to be attributed to a branch as if the profits which branch would have earned at arm's length, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions[4]. To determine the appropriate amount of profits to be attributed to a branch, an analysis on the functions performed, assets used and risks assumed by the branch and the other parts of the enterprise would be required, regardless of the source of income in question. Therefore, the introduction of the AOA by way of the proposed Section 17G could potentially increase the profits tax liability of Hong Kong branches of non-resident FIs if the result from the abovementioned functional analysis does not align with that the profits as determined under the branch accounts as adjusted according to the source rule pertains to Section 14 of the IRO.

[4] Section B-1, Part I of the 2010 Report on the Attribution of Profits to Permanent Establishments, OECD

We illustrate below the anomaly between Hong Kong incorporated FIs and Hong Kong branches of non-resident FIs that Section 17G may create by using the example of trading in overseas listed equities by Hong Kong based traders.

For a Hong Kong incorporated FI engaging in proprietary trading of equities listed on overseas stock exchange, notwithstanding that the traders executing the trade are located in Hong Kong, under the current territorial source principle, the source of trading gains from such overseas listed equities should be outside Hong Kong as the transaction are to be executed via the offshore stock exchange. Hence, regardless of the functions performed by the Hong Kong incorporated FI, the relevant trading gains should not be taxable in Hong Kong pursuant to Section 14 of the IRO. This is also in accordance with the case law principles laid out in the Court of Final Appeal decision in *ING Baring Securities (Hong Kong) Limited v CIR* FACV No. 19 of 2006 (2008).

However, where the proposed Section 17G is introduced under the IRO, a factual and functional analysis has to be undertaken to determine the profits to be attributed to Hong Kong branches of non-resident FIs. Assuming the traders employed by a Hong Kong branch of a non-resident FI engages in the proprietary trading of overseas listed equities using the capital from the headquartered banking entity, notwithstanding the trading gains should be offshore sourced as discussed above, the proposed Section 17G would require a factual and functional analysis of the key entrepreneurial risk-taking activities performed by the Hong Kong branch and the rest of the same enterprise in order to determine the appropriate amount of profits to be attributed to and hence taxed in the hands of the Hong Kong branch. This would likely result in bringing to tax in Hong Kong such profits of the non-resident FI, which are not taxable under the territorial source principles established in Hong Kong.

<u>Introduction of the AOA to be undertaken through comprehensive consultation</u>

While there has been varying adoption of the AOA in different jurisdictions, given its complexities and the far reaching implications involved, extensive study and consultations have been conducted by governments of the jurisdictions looking to adopt the AOA.

Taking Japan as an example, upon spending considerable time and resources to canvass taxpayer views, the Ministry of Finance in Japan released a report in late 2012 and announced its intention to adopt the AOA. Following further discussions and consultation, the plan of implementing the AOA was officially released as one of the most significant reform in its 2014 Tax Reform Outline by the Japanese Cabinet and it is anticipated that the AOA, when drafted, will only be effective from April 2016.

As for Australia, the efforts of incorporating the AOA into the domestic tax legislation date back to 1 November 2011 when the Treasury released a Consultation Paper 'Income tax: cross border profit allocation – Review of transfer pricing rules' (the "Review") examining the need to rewrite Australia's tax law concerning profit allocation. A Discussion Paper on the Review was then released by the Board of Taxation on 31

October 2012. Australia recognizes that the adoption of AOA is of significant importance specifically to the financial sector and this has been reflected through the consultation process. A final report from the Board of Taxation to the Treasury was issued in April 2013. The AOA has not been adopted yet in Australia.

In light of the above international best practice, and given that this is a significant change and a move away from the territorial sourced principles of taxation in Hong Kong and will introduce an inconsistency between Hong Kong incorporated taxpayers and non-resident taxpayers, we strongly recommend that the Government give the proposal due consideration with a proper and thorough consultation process.