

II. REPORT

The date of First Reading of the Bill is 16 December 2015. Members may refer to the LegCo Brief (File Ref: B&M/2/1/66C) issued by Financial Services and the Treasury Bureau on 2 December 2015 for further details.

Object of the Bill

2. The Bill seeks to amend the Inland Revenue Ordinance (Cap. 112) to give profits tax concession to qualifying corporate treasury centres (CTCs); to make provisions for profits tax purposes regarding interests on money borrowed from or lent to associated corporations (ACs); and to treat regulatory capital securities (RCS) as debt securities, and to make consequential and related amendments to the Inland Revenue Rules (Cap. 112A) and the Stamp Duty Ordinance (Cap. 117) concerning RCS.

Background

Operation of CTCs

3. The Financial Secretary announced in the 2015-2016 Budget (see paragraph 99) that, to attract multinational and Mainland enterprises to establish CTCs in Hong Kong to perform treasury services for their group companies, the Government would amend Cap. 112 to allow, under specified conditions, interest deductions under profits tax for CTCs, and to reduce the profits tax for specified treasury activities by 50%.

4. According to the Administration, a CTC is an "in-house bank" within a multinational corporation focusing on the optimal procurement and usage of capital for the operations of the entire group. At present, under section 16 of Cap. 112, if a corporation obtains a loan from a person other than a financial institution¹ (non-FI) in the ordinary course of its intra-group financing business, the interest expense is deductible if the corresponding interest income of that non-FI is chargeable to Hong Kong profits tax. The effect of this is that for a CTC located in Hong Kong engaging in an intra-group financing business, its interest expense payable to ACs outside Hong Kong (being non-FIs whose profits are not subject to Hong Kong tax) is currently not deductible even though the interest income arising from its intra-group financing business is chargeable to profits tax. To attract the establishment of more CTCs, the Administration considers it appropriate to provide relevant tax incentives.

¹ Under section 2(1) of Cap. 112, the term "financial institution" essentially means an authorized institution (i.e. a licensed bank, a restricted licence bank, or a deposit-taking company) within the meaning of section 2 of the Banking Ordinance (Cap. 155) or its relevant associated corporation.

Tax treatment of RCS

5. Under Cap. 112, "debenture" is defined to mean a debenture as defined in section 2(1) of the Companies Ordinance (Cap. 622). Under section 2(1) of Cap. 622, "debenture" is defined, in relation to a company, to include debenture stock, bonds and any other debt securities of the company, whether or not constituting a charge on the assets of the company. According to paragraph 8 of the LegCo Brief, to meet the Basel III requirements², financial institutions (FIs) are strengthening their capital base through, among other means, issuing RCS, including Additional Tier 1 or Tier 2 capital instruments (AT1/T2 instruments), to raise funds. At present, these AT1/T2 instruments do not fall within the definition of "debenture" for the purposes of Cap. 112 and hence their distributions are not deductible for profits tax purposes. The Administration considers it necessary to clarify the tax treatment of RCS.

Key provisions of the Bill

Profits tax concession for qualifying CTCs

6. Division 1 of Part 2 (clauses 3 to 6) of the Bill seeks to amend Cap. 112 to:
- (a) provide for a regime in which the tax rate on qualifying profits of a qualifying CTC derived from qualifying lending transactions, or from qualifying corporate treasury services or qualifying corporate treasury transactions, is 50% of the prevailing profits tax rate for corporations (i.e. $16.5\% \times 50\% = 8.25\%$) (concessionary rate) (new section 14D(1))³;
 - (b) provide for the circumstances under which a qualifying CTC is eligible for the proposed profits tax concession (new sections 14D, 14E and 14F); and
 - (c) provide for adjustments in respect of relevant losses to be set off against the concessionary trading receipts chargeable to the concessionary rate (section 19CA as amended by clause 4).

Interest in respect of borrowing and lending of money with ACs

7. Division 2 of Part 2 of the Bill (clauses 7 to 10) seeks to amend Cap. 112 to:

² The relevant requirements are set out in the Banking (Capital) Rules (Cap. 155L).

³ The new section 14C(1) defines the terms "qualifying profits", "qualifying corporate treasury centre", "qualifying corporate treasury service", "qualifying corporate treasury transaction" and "qualifying lending transaction".

- (a) in the determination of the source of interest income, provide that if a corporation (other than an FI) lends money to a non-Hong Kong associated corporation in the course of its intra-group financing business carried on in Hong Kong, the relevant interest income is regarded as trading receipts derived from Hong Kong, and hence chargeable to profits tax, even though the loan is made available outside Hong Kong (section 15 as amended by clause 7); and
- (b) adjust the existing interest deduction rules to allow a corporate borrower carrying on in Hong Kong an intra-group financing business deduction, from its assessable profits, of interest payable on money borrowed from a non-Hong Kong associated corporation under specified conditions (section 16 as amended by clause 8).

Amendments relating to RCS

8. Division 3 of Part 2 (clauses 11 to 16) of the Bill seeks to amend Cap. 112 to:

- (a) include AT1/T2 instruments⁴ in the proposed definition of "regulatory capital security" in new section 17A(1);
- (b) treat RCS as a debt security for the purposes of profits tax (new section 17B); and
- (c) provide for anti-avoidance of profits tax so as to prevent revenue loss in circumstances where there is half taxation of qualifying profits by qualifying CTCs but full deduction of the corresponding payments by ACs by specifying:
 - (i) the treatment of RCS in an issuer's or its specified connected person's accounts for profits tax assessment (new sections 17C and 17D);
 - (ii) the rules concerning interest deduction if RCS are issued to or for the benefit of, or held by or for the benefit of, a specified connected person (new section 17F); and
 - (iii) the application of the arm's length and the separate enterprise principles (new sections 17E and 17G).

⁴ The new section 17A(1) defines the terms "Additional Tier 1 capital instrument" (referring to Schedule 4B to Cap. 155L) and "Tier 2 capital instrument" (referring to Schedule 4C to Cap. 155L).

Transitional provisions

9. Division 4 of Part 2 (clauses 17 and 18) of the Bill provides for transitional matters in respect of amendments in Divisions 1, 2 and 3 of Part 2 of the Bill.

Consequential and related amendments concerning RCS

10. Part 3 (clauses 19 to 27) of the Bill seeks to:

- (a) make consequential amendments to Cap. 112A and adds transitional provisions for the purpose of ascertaining the profits of a person, other than an FI, having a Hong Kong branch office, but whose head office is situated outside Hong Kong (clauses 19 to 23); and
- (b) amend Cap. 117 to provide for relief of stamp duty for transactions and transfers relating to RCS (clauses 24 to 27).

Commencement

11. The Bill, if passed, would come into operation on the day on which the enacted Ordinance is published in the Gazette.

Public Consultation

12. According to paragraph 19 of the LegCo Brief, the Administration had engaged the treasury profession, the tax advisory sector and the banking industry in formulating the draft provisions of the Bill.

Consultation with LegCo Panel

13. According to the Clerk to the Panel on Financial Affairs, the Panel was consulted on the legislative proposal to revise Cap. 112 for attracting enterprises to establish qualifying CTCs in Hong Kong at the meeting on 1 June 2015. Members supported the proposal in general and raised enquiries/concerns on issues, including the benefits of the proposal and its impacts on Hong Kong's simple taxation regime, measures to prevent abuse of the proposal, and the Administration's efforts in promoting corporate treasury activities and headquarters economy in Hong Kong. However, the Panel was not consulted on the legislative proposal regarding the tax treatment for RCS issued by FIs. When the Panel discussed the implementation of the Basel III standards at the meeting in July 2014, Panel members raised questions on the taxation aspects of RCS and the Administration agreed to clarify the issue.

Conclusion

14. The Legal Service Division is scrutinizing the legal and drafting aspects of the Bill. In view of the implications of the Bill on the profits tax system, members may wish to form a Bills Committee to study the Bill in detail.

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