

**立法會**  
***Legislative Council***

LC Paper No. CB(1)212/18-19(03)

Ref : CB1/BC/1/18

**Bills Committee on Inland Revenue (Amendment) (No. 6) Bill 2018**

**Background brief**

**Purpose**

This paper provides background information on the Inland Revenue (Amendment) (No. 6) Bill 2018 and summarizes the major views expressed by members when issues relating to loss-absorbing capacity ("LAC") requirements for authorized institutions ("AIs") under the resolution regime were discussed by the Panel on Financial Affairs ("FA Panel") in the 2017-2018 legislative session.

**Background**

2. During the financial crisis which began in 2007/2008, a number of governments around the world intervened to support their largest financial institutions ("FIs"), including by bailing them out with public money, in order to allow the financial system to continue to function. This was necessary because of the reliance of individuals, businesses and governments on the services FIs provided and the inadequacy of tools at that time for dealing with the failure of systemically important FIs.

3. The Legislative Council ("LegCo") enacted the Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO") in June 2016 to provide for the legal basis for the establishment of a cross-sectoral resolution regime for within scope FIs<sup>1</sup> in Hong Kong which is designated to meet the international

---

<sup>1</sup> Within scope financial institutions ("FIs") under the Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO") include all authorized institutions ("AIs"), certain financial market infrastructures, certain licensed corporations, certain authorized insurers, certain settlement institutions and system operators of designated clearing and settlement systems, and recognized clearing houses. The scope of FIRO also extends to holding companies and affiliated operational entities of within scope FIs.

standards set by the Financial Stability Board<sup>2</sup> ("FSB") in its "Key Attributes of Effective Resolution Regimes for Financial Institutions". Under FIRO, the Monetary Authority ("MA"), the Securities and Futures Commission and the Insurance Authority are designated as resolution authorities ("RAs") to be vested with a range of powers necessary to effect the orderly resolution of a non-viable systemically important FI for the purpose of maintaining financial stability.

4. There are five stabilization options that an RA may apply to a within scope FI in resolving such FI. These options fall under the following two broad categories:

- (a) four transfer stabilization options, whereby some or all of the assets, rights or liabilities of, or securities issued by, a within scope FI, are transferred to –
  - (i) a purchaser;
  - (ii) a bridge institution;
  - (iii) an asset management vehicle; and/or
  - (iv) (as a last resort) a temporary public ownership company; and
- (b) the bail-in stabilization option, whereby certain liabilities issued by the within scope FI are written down or converted into equity so as to reduce the issuer's debt, thereby absorbing losses and recapitalizing the within scope FI.

5. To enable resolution to be carried out successfully, RAs will be empowered to devise strategies for securing an orderly resolution for a within scope FI and make resolvability assessment to determine whether there are any impediments to the orderly resolution of the FI, and to require the FI to remove any substantive barrier to its orderly resolution.

---

<sup>2</sup> Financial Stability Board ("FSB") was established in April 2009 to coordinate at the international level the work of national financial authorities and international standard-setting bodies and promote the reform of international financial regulations. Hong Kong is a member of FSB.

6. FIRO came into operation on 7 July 2017.<sup>3</sup>

### **Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements — Banking Sector) Rules**

7. Under FIRO, MA is the RA in respect of AIs.<sup>4</sup> MA can initiate a bail-in stabilization option for a failing AI to write down or convert into equity certain liabilities of the AI, thereby restoring the AI to viability. Hence, AIs need to have sufficient LAC, which comprises regulatory capital and certain other liabilities that can readily bear loss in resolution, to facilitate the orderly use of bail-in stabilization option.

8. The Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements — Banking Sector) Rules ("FIRO LAC Rules") are made by MA under section 19 of FIRO to prescribe LAC requirements for AIs and their group companies requiring them to maintain minimum levels of LAC, which can be used to absorb losses and provide recapitalization resources to facilitate orderly resolution should the relevant AI ceases, or become likely to cease, to be viable.

9. The major proposals of the FIRO LAC Rules include the scope of institutions that will be covered, calibration of minimum requirements, qualifying criteria for LAC instruments, restrictions on the sale and marketing of LAC instruments and other safeguards. The FIRO LAC Rules were gazetted on 19 October 2018, tabled at LegCo on 24 October 2018 for negative vetting,<sup>5</sup> and will come into operation on 14 December 2018.

### **The Inland Revenue (Amendment) (No. 6) Bill 2018**

10. LAC instruments consist of (a) regulatory capital instruments (namely Common Equity Tier 1 ("CET1") capital instruments, Additional Tier 1 ("AT1") capital instruments and Tier 2 ("T2") capital instruments); and (b) other

---

<sup>3</sup> The Financial Institutions (Resolution) Ordinance (Commencement) Notice 2017 appointed 7 July 2017 as the date on which all provisions of FIRO (except for Part 8 (sections 144 to 148), section 192 and Division 10 of Part 15 (sections 228 to 232)) commence.

<sup>4</sup> Under the Banking Ordinance (Cap. 155), an AI means a bank, a restricted licence bank or a deposit-taking company.

<sup>5</sup> A subcommittee was formed to study the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements — Banking Sector) Rules ("FIRO LAC Rules") at the House Committee meeting on 26 October 2018.

LAC-eligible liabilities. Unlike CET1 capital instruments (which are equity in nature), AT1 capital instruments, T2 capital instruments and other LAC-eligible liabilities (collectively "LAC debt instruments") are hybrid<sup>6</sup> in nature. Their hybrid nature raises questions about their tax treatment, in particular whether they are eligible for debt-like tax treatment under the Inland Revenue Ordinance (Cap. 112) ("IRO"). To address the uncertainty in tax treatment in respect of AT1 and T2 capital instruments issued by AIs under the regulatory capital regime, IRO was amended in 2016 to provide debt-like tax treatment for these instruments. Other LAC-eligible liabilities were not covered in the amendment exercise in 2016 as FIRO and the FIRO LAC Rules were not then in place. Hence, the Administration considers it necessary to amend IRO to remove tax uncertainty over other LAC-eligible liabilities with a view to facilitating the implementation of the FIRO LAC Rules.

11. The Administration introduced the Inland Revenue (Amendment) (No. 6) Bill 2018 ("the Amendment (No. 6) Bill 2018") into LegCo at the Council meeting of 31 October 2018. The Amendment (No. 6) Bill 2018 seeks to amend IRO to –

- (a) treat certain LAC debt instruments as debt securities for profits tax purposes;
- (b) deem certain sums received by or accrued to certain entities by way of interest or sale of a regulatory capital security ("RCS") as trading receipts;
- (c) allow deduction of interest on money borrowed by certain entities in respect of a RCS in ascertaining chargeable profits;
- (d) provide that certain entities are not eligible to be qualifying corporate treasury centres ("CTCs"); and
- (e) provide for related matters.

12. The major proposals and the main provisions of the Amendment (No. 6) Bill 2018 are set out in the ensuing paragraphs.

---

<sup>6</sup> While their legal form is debt-like, LAC debt instruments have an equity-like loss-absorbing feature as they can be converted into equity, or be written down, to absorb losses at the point of non-viability of the relevant AI (which is the issuer itself or, where the issuer is not an AI, the principal AI to which the issuer is related).

Treating certain loss-absorbing capacity debt instruments as debt securities for profits tax purposes

13. Clause 8 seeks to amend section 17A(1) of IRO by expanding the definition of RCS to include LAC debt instruments; and amending the definitions of "fair value" and "fair value accounting" to encompass their application to RCS. The effect of the proposed amendments is that the following instruments will be treated as debt securities, and hence distributions arising from the securities (other than repayment of the paid-up amount) will be treated as interest expenses and thereby deductible for profits tax purposes:

- (a) LAC debt instruments issued by AIs;
- (b) all LAC debt instruments issued by a LAC banking entity<sup>7</sup>; and
- (c) all instruments issued by a non-Hong Kong incorporated AI under a LAC-equivalent requirement<sup>8</sup> of a non-Hong Kong jurisdiction.

Deeming certain amounts as trading receipts chargeable to tax

14. Clause 6 of the Bill seeks to amend section 15 of IRO by adding new sections 15(1)(ib), 15(1)(lb) and 15(1D) to deem the following sums as taxable trading receipts for profits tax purposes:

- (a) certain sums received by or accrued to a LAC banking entity by way of interest in respect of a RCS (proposed section 15(1)(ib)); and
- (b) certain sums received by or accrued to a LAC banking entity in connection with its business from the sale or other disposal, or on the redemption, of a RCS (proposed section 15(1)(lb)).

---

<sup>7</sup> Under the proposed amendment to section 2(1) of the Inland Revenue Ordinance (Cap. 112) ("IRO"), a LAC banking entity means an Hong Kong affiliated operational entity, or a clean Hong Kong holding company as defined by rule 2(1) of the LAC Rules, that is required to meet banking LAC requirement under those Rules.

<sup>8</sup> Under paragraph (c) of the definition of "loss-absorbing capacity" in rule 2(1) of the FIRO LAC Rules referred to in clause 8(3)(e) of the Bill, LAC-equivalent requirement includes a requirement designed to reflect the principles set out in the *Principles on Loss-absorbing and Recapitalisation Capacity of global systemically important bank in Resolution and Total Loss-absorbing Capacity Term Sheet* issued by FSB.

15. The effect of the above proposed amendments is that interest, gains or profits received by or accrued to an AI or its Hong Kong affiliated operational entity ("AOE") or clean Hong Kong holding company ("Holding Company") from all LAC debt instruments will be deemed trading receipts and thus chargeable to profits tax.

#### Interest expense deduction for loss-absorbing capacity debt instruments

16. Clause 7 seeks to add new sections 16(2)(ab) and 16(2AAB) to IRO so that the same profits tax treatment currently afforded to interest payable by FIs would be extended to a LAC banking entity. The effect of the new sections is that tax deduction will be allowed for interest payable by an AOE or a clean Holding Company of an AI in respect of all LAC debt instruments issued by the AOE or clean Holding Company.

#### Loss-absorbing capacity banking entity not eligible to be qualifying corporate treasury centres

17. Clauses 4 and 5 of the Bill seek to amend sections 14D and 14F of IRO respectively to provide that a LAC banking entity is also not eligible to be a qualifying CTC for the purposes of profits tax concession.<sup>9</sup>

#### Anti-avoidance provisions

18. Clause 10 seeks to amend sections 17E and 17F of IRO to provide that the existing constraints and anti-avoidance provisions currently applicable to interest expenses deduction by AIs in respect of AT1 and T2 capital instruments will also apply to a LAC banking entity and its associate in respect of all LAC debt instruments. These include: (a) the application of the arm's length principle so that chargeable profits from transactions of LAC debt instruments between an AI or its LAC banking entity and its associate will be assessed by reference to the amount of profits that would have accrued had the same transaction been carried out at arm's length terms between parties who are not associated; and (b) restrictions and conditions on deduction for sums payable in respect of LAC debt instruments issued to, held by, or issued or held for the benefit of a specified connected person of the issuer of a RCS.

---

<sup>9</sup> Under section 14D of IRO, the assessable profits of a corporation that is a qualifying corporate treasury centre ("CTC") for a year of assessment may enjoy profits tax concession (i.e. 50% of the prevailing profits tax rate for corporations). Section 14D(9) provides that a FI is not eligible to be a qualifying CTC. Under section 14D(2) of IRO, a corporation is a qualifying CTC if it has carried out in Hong Kong one or more corporate treasury activities, namely carrying on an intra-group financing business, providing a corporate treasury service or entering into a corporate treasury transaction within the meaning of section 14C(1) of IRO.

19. The details of the Amendment (No. 6) Bill 2018 are explained in paragraph 25 of the LegCo Brief (File Ref: B&M/2/1/29/4/1C(2018)) dated 16 October 2018 issued by the Financial Services and the Treasury Bureau and the Hong Kong Monetary Authority ("HKMA"), and paragraphs 6 to 17 of the Legal Service Division Report on the Amendment (No. 6) Bill 2018 (LC Paper No. LS8/18-19).

20. The Amendment (No. 6) Bill 2018, if passed, would come into operation on the day on which it is published in the Gazette as an Ordinance. According to the Administration, it aims to commence the Amendment (No. 6) Bill 2018, upon enactment, on or after the FIRO LAC Rules have taken effect (i.e. on or after 14 December 2018).

### **Major views and concerns expressed by Members**

21. The Administration briefed the FA Panel on the proposed rules on LAC requirements for AIs and the proposed amendments to IRO in relation to LAC debt instruments at the meeting on 3 April 2018. The major views expressed by members are summarized in the ensuing paragraphs.

#### Tax treatment of loss-absorbing capacity debt instruments

22. Panel members noted that IRO was amended in 2016 to provide debt-like tax treatment to AT1 and T2 capital instruments issued by AIs but other LAC-eligible liabilities were not covered in that amendment exercise as FIRO and the FIRO LAC Rules were not then in place. Hence the Administration proposed to amend IRO to remove tax uncertainty over other LAC-eligible liabilities to facilitate implementation of the FIRO LAC Rules. Enquiries were raised as whether there was any other type of debt instruments set by the Basel Committee on Banking Supervision that had not been implemented in Hong Kong and would require further amendments to IRO in the future; and whether the proposed tax treatment would cover LAC debt instruments issued by global systematically important banks in Hong Kong.

23. The Administration responded that it would keep in view the development of relevant international regulatory standards and amend IRO for effective implementation of new international standards and requirements where necessary. The amendments to IRO in 2016 covered both Hong Kong incorporated AIs and overseas AIs with branches in Hong Kong. In other words, regulatory capital securities issued by overseas AIs and Hong Kong incorporated AIs would receive the same tax treatment. In the proposed amendments to IRO in relation to LAC debt instruments, the proposed tax

treatment would also cover Hong Kong incorporated clean holding companies of AIs which were subject to LAC requirement.

#### Public consultation on the legislative proposals on loss-absorbing capacity

24. Panel members sought details on the responses received during the two-month public consultation<sup>10</sup> on the legislative proposals on LAC. The Administration advised that 10 responses were received during the public consultation, including a number of responses from the banking industry. Respondents from the banking industry had stressed the need to ensure consistency of the FIRO LAC Rules with the relevant international standards issued by FSB, and for HKMA to closely liaise with overseas RAs when implementing LAC requirements for cross-border AIs. HKMA advised that it would set out the implementation details of LAC requirements in a code of practice to provide guidance to AIs.

#### **Latest development**

25. At the House Committee meeting on 2 November 2018, Members agreed to form a Bills Committee to study the Amendment (No. 6) Bill 2018.

#### **Relevant papers**

26. A list of relevant papers is in the **Appendix**.

Council Business Division 1  
Legislative Council Secretariat  
26 November 2018

---

<sup>10</sup> The Hong Kong Monetary Authority ("HKMA") conducted a two-month public consultation from 17 January to 16 March 2018 on the legislative proposals on LAC and released the consultation conclusions on 25 July 2018. HKMA further issued the text of the draft FIRO LAC Rules and the draft Inland Revenue (Amendment) (No. 6) Bill 2018 for industry consultation on 25 July 2018.

## List of relevant papers

Date	Event	Paper/minutes of meeting
22 June 2016	The Legislative Council passed the Financial Institutions (Resolution) Bill	<a href="#">Hansard</a> <a href="#">The Bill passed</a> <a href="#">Report of the Bills Committee</a> (LC Paper No. CB(1)1032/15-16)
22 November 2016 and 6 April 2017	Consultation paper and the consultation conclusion on protected arrangements regulations jointly issued by the authorities	<a href="#">Consultation paper</a> <a href="#">Consultation conclusion</a>
18 April 2017	Meeting of the FA Panel	<a href="#">Administration's paper</a> (LC Paper No. CB(1)777/16-17(05)) <a href="#">Background brief</a> (LC Paper No. CB(1)777/16-17(06)) <a href="#">Minutes</a> (paragraphs 29-41) (LC Paper No. CB(1)1344/16-17)
17 May 2017	Subcommittee on Financial Institutions (Resolution) (Protected Arrangements) Regulation and Financial Institutions (Resolution) Ordinance (Commencement) Notice 2017	<a href="#">Report of the Subcommittee</a> (LC Paper No. CB(1)1205/16-17)

<b>Date</b>	<b>Event</b>	<b>Paper/minutes of meeting</b>
17 January 2018	Consultation paper and the consultation conclusion on rules for loss-absorbing capacity requirements for authorized institutions under Financial Institutions (Resolution) Ordinance issued by the Hong Kong Monetary Authority	<a href="#">Consultation paper</a> <a href="#">Consultation conclusion</a>
3 April 2018	Meeting of the FA Panel	<a href="#">Administration's paper</a> (LC Paper No. CB(1)724/17-18(06))  <a href="#">Background brief</a> (LC Paper No. CB(1)724/17-18(07))  <a href="#">Minutes</a> (paragraphs 45-48) (LC Paper No. CB(1)1178/17-18)
24 October 2018	The Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules were tabled in the Legislative Council	<a href="#">Legislative Council Brief</a> (File Ref: B&M/2/1/29/4/1C(2018))  <a href="#">Legal Service Division Report</a> (LC Paper No. LS5/18-19)
31 October 2018	The Inland Revenue (Amendment) (No. 6) Bill 2018 was introduced into the Legislative Council	<a href="#">The Bill</a>  <a href="#">Legislative Council Brief</a> (File Ref: B&M/2/1/29/4/1C(2018))  <a href="#">Legal Service Division Report</a> (LC Paper No. LS8/18-19)