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By email: bc_01_18@legco.gov.hk

Bills Committee on Inland Revenue (Amendment) (No. 6) Bill 2018
Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong

Dear Sirs

Inland Revenue (Amendment) (No. 6) Bill 2018

We refer to the subject Amendment Bill which aims to provide certainty of tax treatment for loss-absorbing capacity (“LAC”) debt instruments issued by authorized institutions and relevant group companies, in facilitating the implementation of the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements - Banking Sector) Rules.

We very much appreciate the Government’s efforts in introducing the Bill to provide debt-like tax treatment to qualifying LAC debt instruments which is essential to maintain a level playing field for banking entities in Hong Kong vis-à-vis their peers in other international financial centers.

While the Bill is generally well received and supported by the industry, we would like to reiterate the key concern made in our last submission dated 5 September 2018 to Hong Kong Monetary Authority (“HKMA”) with respect to section 17F(3) of the Inland Revenue Ordinance (“IRO”). An extract of this submission is reproduced as the **Appendix** for the Bills Committee’s information.

We note the response provided by HKMA that it is necessary to retain section 17(F(3)). We remain of the view that the response does not adequately address the concern nor does it justify the inclusion of section 17F(3) following the introduction of comprehensive transfer pricing rules in Hong Kong in 2018. Notwithstanding the transfer pricing rules, section 17F(3) can impose a restriction on interest deductions even in cases where Regulatory Capital Securities (“RCS”) or LAC debt issuances between related parties are conducted on wholly arm’s length terms.

We appreciate that it is the Government’s intention for section 17F(3) to provide an anti-avoidance safeguard to disallow any interest considered to be excessive in the case of an issuance of RCS or LAC debt instruments to an overseas related party. Where tax avoidance is the motive and the interest charge clearly is excessive we would agree that the safeguard is

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appropriate. However, we would assert that interest that is clearly on arm's length terms cannot be excessive nor have an avoidance motive in this context and should be excepted from the scope of section 17F(3).

If the repeal of section 17F(3) as requested in our prior submission is not possible, we would request that clear guidance be provided to the banking industry that section 17F(3) will not be invoked to disallow any interest deduction for a bona fide intra-group issuance of RCS or LAC debt instruments on arm's length terms. Therefore, if it is considered that repealing section 17F(3) in full is not possible or appropriate, then as an alternative, we strongly suggest the Inland Revenue Department ("IRD") clearly articulate in Departmental Interpretation & Practice Note No. 53 that section 17F(3) is an anti-abuse provision, so will only be invoked if a financial institution is found to have engaged in a tax avoidance transaction which involves the issue of RCS/LAC to Specified Connected Person and, for these purposes and in this context, transactions undertaken on arm's length terms will not be considered abusive or undertaken for tax avoidance purposes. Language similar to that included in paragraph 34 of DIPN 53 in relation to the scope of application of section 17G of the IRO would help to achieve this clarity of application. This would help to ensure that section 17F(3) does not produce inequitable tax outcomes for bona fide issuance of RCS/LAC on arm's length terms as described in the scenarios set out in the **Appendix**.

We would be pleased to address any questions from the Bills Committee if required.

Yours faithfully

 Steve Choi
Secretary

Enc.

Section 17F(3) of the IRO

The existing section 17F(3) seeks to limit the interest deduction of an FI or LAC banking entity in respect of an RCS to the sum payable by their SCP or associated corporation on any externally issued RCS, debenture or debt instrument.

The provision, if rigidly applied, has the potential to deny a deduction for RCS interest that would have been deductible if that same, arm's-length, amount of interest were payable on externally issued RCSs (as opposed to an internal issuance to an SCP) under the same terms by the FI or LAC banking entity.

There are many genuine and legitimate commercial factors that may result in the arm's length interest payable by an FI or LAC banking entity exceeding the interest payable on the external issuance of RCS by their SCP. For instance, where the credit rating of the FI or LAC banking entity is higher than their SCP; differences in the timing of the external and Hong Kong issuance and hence different prevailing market interest rates.

The cap on the deduction of interest for the issuers of RCS also conflicts with the arm's length principles under section 17E and section 50AAF and is not aligned with the international transfer pricing practices and tax treaties that Hong Kong has entered into.

We urge HKMA and IRD take the opportunity to repeal section 17F(3) in full in light of the newly introduced transfer pricing provisions to ensure arm's-length pricing that aligns with international practice and the tax treaties entered into by Hong Kong and to ensure that the IRO does not produce inequitable tax outcomes as described in the scenarios we have referenced.