Bills Committee on Inland Revenue (Amendment) (No. 6) Bill 2018
Government's responses to written submissions

This paper sets out the Government's response to the submissions from various organisations to the Bills Committee on Inland Revenue (Amendment) (No.6) Bill 2018 ("the Bill").

2. We welcome the general support of the Bill to provide certainty of the tax treatments for loss-absorbing capacity ("LAC") debt instruments issued by authorized institutions and relevant group companies under the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules (Cap. 628B) ("the Rules").

Key Comments

Section 17F(3) of the Inland Revenue Ordinance (Cap. 112) ("IRO") can impose a restriction on interest deductions in relation to regulatory capital securities ("RCS") or LAC debt instruments. Section 17F(3) should be repealed or clear guidance should be provided to the banking industry that section 17F(3) will not be invoked to disallow any interest deduction for a bona fide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. (Organisation: Hong Kong Association of Banks)

3. The Bill has not proposed to change the framework under the IRO for deduction of interest in respect of regulatory capital security ("RCS"). In general, section 17F ensures that the deductible amount is an actual expense paid to third parties by imposing the following conditions and restrictions: (i) interest is deductible only if the money paid by the specified connected person for the purchase of the RCS was entirely funded by the proceeds of an external issue of a RCS, debenture or debt instrument to a third party (section 17F(2)); and (ii) the amount of interest deductible is restricted to the amount of interest payable to the third party (section 17F(3)).

4. Section 17F is a specific anti-avoidance provision to restrict the issuer's deduction of interest if the RCS is issued to, held by or issued or

held for benefit of a specified connected person. In this case, interest income arising from the RCS is not taxable in Hong Kong and there would be asymmetry in taxation of income and deduction of expenses. In the absence of withholding tax and "thin capitalization rules" in Hong Kong, the conditions and restrictions on interest deduction in section 17F are necessary to safeguard against revenue loss that might be caused by tax avoidance schemes that attempt to take advantage of the lack of symmetry in tax treatment on interest income and interest expense.

5. We noted that during the meeting of the Bills Committee held on 27 November 2018, members raised concerns about whether the Bill contained anti-avoidance provisions for "back-to-back transactions". Certainly, section 17F is one of the anti-avoidance provisions. The cap on interest deduction as provided in section 17F(3) is neither related to transfer pricing nor related to the arm's length principle/international transfer pricing practices. While section 17F(3) restricts the amount of interest deduction, there is nothing to restrict the payment of appropriate remuneration to the overseas related party for the role it plays in managing the RCSs of the group.

6. In conclusion, we consider that section 17F(3) should be retained. In ascertaining the amount of interest deductible under section 17F(3), the Inland Revenue Department would consider the totality of facts and in particular, whether fees were charged by the specified connected person, whether the relevant transactions are at arm's length, whether the specified connected person is chargeable to tax in other tax jurisdiction in respect of the interest income and whether the arrangement have features of an arrangement for tax avoidance.

Certain LAC debt instruments, in particular Tier 2 ("T2") capital instruments and non-capital LAC debt instruments, are purely debt securities despite their loss-absorbing capacity. Payments made under this kind of LAC debt instruments should be eligible for an interest expense deduction both before and after the enactment of the Bill. (Organisation: PricewaterhouseCoopers Ltd.)

7. We do not agree that T2 capital instruments and non-capital LAC debt instruments are purely debt in nature. As we have mentioned in

paragraphs 12 and 13 of the Legislative Council Brief (File Ref: B&M/2/1/29/4/1C(2018), unlike Common Equity Tier 1 ("CET1") capital instruments (which are equity in nature), LAC debt instruments (including Additional Tier 1 ("AT1") capital instruments, T2 capital instruments and non-capital LAC debt instruments) are hybrid in nature. 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 authorized institution. Their hybrid nature raises questions about their tax treatment. To address the tax uncertainty in respect of AT1 capital instruments and T2 capital instruments issued by authorized institutions under the regulatory capital regime, the IRO was amended in 2016 to provide debt-like tax treatment for these instruments. Now, similar amendments are proposed in this Bill to provide debt-like tax treatment for non-capital LAC debt instruments.

8. For T2 capital instruments, section 7(b) of Schedule 36 to the IRO provides that sections 16(2AA) and 17B apply only to sums payable, in respect of a RCS, on or after the commencement date (i.e. 3 June 2016, the day on which the Inland Revenue (Amendment) (No. 2) Ordinance 2016 came into operation). In other words, sums payable, in respect of T2 capital instruments, on or after 3 June 2016 are treated as interest and are eligible for deduction in accordance with section 16(1)(a), subject to sections 17B, 17C, 17D, 17E, 17F and 17G. The relevant provisions are not applicable to sums payable, in respect of T2 capital instruments, before 3 June 2016.

9. For non-capital LAC debt instruments, section 6(b) of the proposed Schedule 47 to the IRO provides that sections 16(1)(a), (2AA) and 17B apply only to sums payable, in respect of a specified instrument, on or after the enactment of the Bill. In other words, sums payable, in respect of non-capital LAC debt instruments, on or after the enactment of the Bill will be treated as interest and will be eligible for deduction in accordance with section 16(1)(a), subject to sections 17B, 17C, 17D, 17E, 17F and 17G. The Monetary Authority's current planning assumptions are that any classification of resolution entities and material subsidiaries

under the Rules will be made after the Bill has come into operation[1]. On these assumptions, all sums payable in respect of such non-capital LAC debt instruments would be eligible for the proposed interest deduction.

Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
Inland Revenue Department
21 December 2018

[1] In respect of domestically-important banks that are part of non-emerging market economy headquartered global systemically-important bank groups as mentioned in paragraph 7 of the Consultation Conclusion on Rules on Loss-Absorbing Capacity Requirements for Authorized Institutions published on 25 July 2018. See: https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/resolution/LAC_CP_conclusion_ENG.pdf.