

II. REPORT

The date of First Reading of the Bill is 31 October 2018. Members may refer to the Legislative Council ("LegCo") Brief (File Ref: B&M/2/1/29/4/1C(2018)) issued by the Financial Services and the Treasury Bureau and Hong Kong Monetary Authority ("HKMA") on 16 October 2018 for further details.

Object of the Bill

2. The Bill seeks to amend the Inland Revenue Ordinance (Cap. 112) to:
 - (a) treat certain loss-absorbing capacity¹ ("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.

Background

3. Under section 17B of Cap. 112, a RCS is to be treated as a debt security for profits tax purposes, and any sum payable in respect of a RCS by its issuer, other than a repayment of the paid-up amount of the security, is to be treated as interest payable on money borrowed by the issuer of an amount equal to the paid-up amount of the security. Under section 17A(1) of Cap. 112, RCS is defined to mean a security that qualifies or has qualified as an Additional Tier 1 ("AT1") capital instrument or a Tier 2 ("T2") capital instrument².

¹ Under section 19(9) of the Financial Institutions (Resolution) Ordinance (Cap. 628), loss-absorbing capacity, in relation to an entity, means a financial resource that is capable, in the event of the entity ceasing, or becoming likely to cease, to be viable, of being used to absorb losses of the entity and contribute to the restoration of its capital position.

² Under section 17A(1) of Cap. 112, AT1 capital instrument means a capital instrument that qualifies as AT1 capital under Schedule 4B to the Banking (Capital) Rules (Cap. 155L), or under the equivalent laws of regulatory requirements of another member jurisdiction of the Basel Committee on Banking Supervision ("Basel Committee"), and T2 capital instrument means a capital instrument that qualifies as T2 capital under Schedule 4C to Cap. 155L, or under the equivalent laws of regulatory requirements of another member jurisdiction of the Basel Committee.

4. Under the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules (L.N. 195 of 2018) ("the LAC Rules"), which were gazetted on 19 October 2018 and tabled in LegCo on 24 October 2018³, within scope financial institutions ("FIs") in the banking sector are required to maintain minimum levels of LAC which may be met with external or internal LAC debt instruments. According to paragraph 13 of the LegCo Brief, to facilitate the implementation of the LAC Rules, the Administration considers it necessary to amend Cap. 112 to provide debt-like tax treatment for LAC debt instruments.

Provisions of the Bill

5. The main provisions and major features of the Bill are set out below.

Treating certain LAC debt instruments as debt securities for profits tax purposes

6. Clause 8 seeks to amend section 17A(1) of Cap. 112 by:

- (a) expanding the definition of RCS to include LAC debt instruments; and
- (b) amending the definitions of "fair value" and "fair value accounting" to encompass their application to RCS.

7. The effect of the above proposed amendments, if passed, is that the following instruments, similar to AT1 and T2 capital instruments, would be treated as debt securities so that distributions arising from the securities (other than repayment of the paid-up amount) should be treated as interest expenses and hence deductible for profits tax purposes:

- (a) LAC debt instruments issued by authorized institutions⁴ ("AIs"),
- (b) all LAC debt instruments issued by a LAC banking entity⁵; and
- (c) all instruments issued by a non-Hong Kong incorporated AI under a LAC-equivalent requirement⁶ of a non-Hong Kong jurisdiction.

³ A subcommittee was formed to study the LAC Rules at the meeting of House Committee on 26 October 2018.

⁴ Under the Banking Ordinance (Cap. 155), an authorized institution means a bank, a restricted license bank or a deposit-taking company.

⁵ Under the proposed amendment to section 2(1) of Cap. 112, a LAC banking entity means an HK affiliated operational entity, or a clean HK holding company as defined by rule 2(1) of the LAC Rules, that is required to meet banking LAC requirement under those Rules.

⁶ Under paragraph (c) of the definition of "loss-absorbing capacity" in rule 2(1) of the 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 the Financial Stability Board, of which Hong Kong is a member jurisdiction.

8. Schedule 9 to the Stamp Duty Ordinance (Cap. 117) provides for stamp duty exemption in relation to transactions and transfers of RCS and adopts the same meaning of RCS as in section 17A of Cap. 112. If the amendments to the definition of RCS proposed in the Bill are passed, the effect would be that transfers of LAC debt instruments would be exempt from stamp duty under Cap. 117. This would extend the current stamp duty treatment for transfers of AT1 and T2 capital instruments to all LAC debt instruments issued by the relevant AIs.

Deeming certain amounts as trading receipts chargeable to tax

9. Under section 15 of Cap. 112, only those interest, gains or profits derived from AT1 and T2 capital instruments are deemed trading receipts.

10. Clause 6 of the Bill seeks to amend section 15 of Cap. 112 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)).

11. The effect of the proposed amendments to section 15 of Cap. 112 is that interest, gains or profits received by or accrued to an AI or its HK affiliated operational entity ("AOE") or clean HK holding company ("Holding Company") from all LAC debt instruments will be deemed trading receipts and thus chargeable to profits tax.

Interest expense deduction for LAC debt instruments

12. Under section 16(2)(a) of Cap. 112, interest payable on money borrowed by a FI (including an AI) is eligible for tax deduction in ascertaining chargeable profits. Clause 7 seeks to add new sections 16(2)(ab) and 16(2AAB) to Cap. 112 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 would 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.

LAC banking entity not eligible to be qualifying CTCs

13. Under section 14D of Cap. 112, the assessable profits of a corporation that is a qualifying CTC⁷ 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. Clauses 4 and 5 of the Bill seek to amend sections 14D and 14F of Cap. 112 respectively to provide that a LAC banking entity is also not eligible to be a qualifying CTC for the purposes of profits tax concession.

Anti-avoidance provisions

14. Clause 10 seeks to amend sections 17E and 17F of Cap. 112 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 would also apply to a LAC banking entity and its associate in respect of all LAC debt instruments.

15. Under the proposed section 17E, chargeable profits from transactions of LAC debt instruments between an AI or its LAC banking entity and its associate would 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.

16. The proposed new section 17F(9A) seeks to provide for 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.

Other amendments

17. Other amendments relate to transitional, consequential and textual amendments.

Commencement

18. The Bill, if passed, would come into operation on the day on which it is published in the Gazette as an Ordinance. According to paragraph 27 of the LegCo Brief, the Administration aims to commence the Bill, upon enactment, on or after the LAC Rules have taken effect (i.e. on or after 14 December 2018).

⁷ Under section 14D(2) of Cap. 112, 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 Cap. 112.

Public Consultation

19. According to paragraph 31 of the LegCo Brief, HKMA conducted a two-month public consultation (from 17 January to 16 March 2018) on the legislative proposals on LAC (including the proposed amendments to Cap. 112). Certain key stakeholders were engaged during the consultation period. Most comments received by HKMA were technical in nature. The Administration had considered the views received in formulating the legislative proposal and further consulted the industry on the draft text of the Bill from 25 July to 5 September 2018.

Consultation with LegCo Panel

20. As advised by the Clerk to the Panel on Financial Affairs, the Panel was briefed by the Administration on the proposed amendments in relation to LAC debt instruments in Cap. 112 on 3 April 2018. Members had no objection to the introduction of the Bill into the LegCo. The Panel discussed the coverage of the proposed tax treatment in relation to interest expense deduction for LAC debt instruments, particularly whether LAC debt instruments issued by global systemically important banks in Hong Kong would be covered, and whether further amendments to Cap. 112 would be required in future to cover other types of debt instruments set by the Basel Committee on Banking Supervision.

Conclusion

21. The Legal Service Division is scrutinizing the legal and drafting aspects of the Bill. Members may consider whether to form a Bills Committee to study the Bill in detail.

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