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Paper for the House Committee meeting on 18 January 2019

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

Purpose

This paper reports on the deliberations of the Bills Committee on Inland Revenue (Amendment) (No. 6) Bill 2018 ("the Bills Committee").

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 (the major provisions of which came into operation on 7 July 2017) to provide for the legal basis for the establishment of a cross-sectoral resolution regime for within scope FIs¹ in Hong Kong. Under FIRO, the Monetary Authority ("MA"), the Securities and Futures Commission and the Insurance Authority are resolution authorities ("RAs") for those FIs that fall within the scope of FIRO and operate under their

¹ 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.

respective purviews. The RAs are vested with a range of powers necessary to effect the orderly resolution of non-viable systemically important FIs 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. Under the bail-in stabilization option,² certain liabilities issued by a within scope FI are written down or converted into equity so as to reduce the within scope FI's debt, thereby absorbing losses and recapitalizing the within scope FI.

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

5. Under FIRO, MA is the RA of authorized institutions ("AIs")³, amongst others. Subject to certain conditions set out in FIRO, 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. But some liabilities (e.g. subordinated, unsecured debt) can be more easily bailed in than others. For the bail-in stabilization option to be effective, AIs in resolution must have a sufficient stock of liabilities that can be readily bailed in. In other words, AIs need to maintain sufficient loss-absorbing capacity ("LAC") for bearing loss in resolution.

6. In order to require AIs and their group companies to maintain minimum levels of LAC, MA made the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements — Banking Sector) Rules ("LAC Rules") in October 2018.⁴ The LAC Rules commenced operation on 14 December 2018.

7. The LAC Rules provide that where a preferred resolution strategy envisages the application of one or more stabilization options to an AI, a holding company of an AI or an affiliated operational entity ("AOE") of an AI,⁵

² The other four transfer stabilization options involve the transfer of some or all of the assets, rights or liabilities of, or securities issued by a within scope FI to a purchaser, a bridge institution, an asset management vehicle, and/or a temporary public ownership company.

³ Under Banking Ordinance (Cap. 155), an AI means a bank, a restricted licence bank or a deposit-taking company.

⁴ The Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements — Banking Sector) Rules ("LAC Rules") are made by the Monetary Authority under section 19(1) of FIRO and are subject to the negative vetting procedure of the Legislative Council ("LegCo"). A Subcommittee has been formed to study the LAC Rules. The report of the Subcommittee (LC Paper No. CB(1)265/18-19) is available at <https://www.legco.gov.hk/yr18-19/english/hc/papers/hc20181130cb1-265-e.pdf>.

⁵ Under FIRO, an affiliated operational entity, in relation to a within scope FI, means a body

which in each case is incorporated in Hong Kong, MA may classify that entity as a "resolution entity". A resolution entity must meet a LAC requirement with external LAC instruments that are issued to an entity outside its resolution group ("external LAC requirement"). External LAC instruments can be used in resolution to absorb losses experienced by a resolution entity and provide recapitalization resources to such entity.

8. The LAC Rules also provide that MA may classify an AI, a holding company of an AI or an AOE of an AI, which in each case is incorporated in Hong Kong, that is in a resolution group (or overseas equivalent) but is not itself a resolution entity as a "material subsidiary". A material subsidiary must meet a LAC requirement with internal LAC instruments that are issued, directly or indirectly, to the resolution entity in the material subsidiary's resolution group ("internal LAC requirement"). Internal LAC instruments can be contractually written down or converted into equity in case of the non-viability of a material subsidiary, thereby passing losses up to the resolution entity in its resolution group and restoring the material subsidiary to viability without it having to go into resolution itself.

The Bill

9. LAC instruments consist of (a) regulatory capital instruments (namely Common Equity Tier 1 ("CET1") capital instruments, eligible Additional Tier 1 ("AT1") capital instruments and eligible Tier 2 ("T2") capital instruments); and (b) other LAC-eligible liabilities. Unlike CET1 capital instruments (which are equity in nature), AT1 capital instruments, T2 capital instruments and other LAC-eligible liabilities (collectively referred as "LAC debt instruments") are hybrid in nature. While the legal form of LAC debt instruments is debt-like, such 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). 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 (i.e. the Inland Revenue (Amendment) (No. 2) Ordinance 2016) to provide debt-like tax treatment for these instruments. LAC-eligible liabilities other than AT1 capital instruments and T2 capital instruments (hereafter referred as "non-capital LAC debt instruments") were not covered in the amendment exercise in 2016 as FIRO and the LAC Rules were not then in

corporate that is a group company of the FI and that provides services, directly or indirectly, to the FI.

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 LAC Rules.

10. The Inland Revenue (Amendment) (No. 6) Bill 2018 ("the Bill") was introduced into LegCo at the Council meeting of 31 October 2018. The Bill 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 an RCS in ascertaining chargeable profits;
- (d) provide that certain entities are not eligible to be qualifying corporate treasury centres; and
- (e) provide for related matters.

11. The proposals in and major provisions of the Bill are set out in **Appendices I and II** respectively. The Bill, if passed, will come into operation on the day on which it is published in the Gazette as an Ordinance.

12. It is also the Administration's policy intention to exempt the transfer of non-capital LAC debt instruments from stamp duty under the Stamp Duty Ordinance (Cap. 117) ("SDO"). As a result of amending the definition of RCS under IRO, transfers of all LAC debt instruments will be exempt from stamp duty under SDO.

The Bills Committee

13. At the House Committee meeting on 2 November 2018, Members agreed to form a Bills Committee to study the Bill. The membership list of the Bills Committee is in **Appendix III**. Under the chairmanship of Hon Kenneth LEUNG, the Bills Committee has held one meeting to study the Bill. The Bills Committee has also invited written views on the Bill and received two submissions. A list of the organizations which have provided written views to the Bills Committee is in **Appendix IV**.

Deliberations of the Bills Committee

14. Members of the Bills Committee note that the purposes of the Bill are to provide certainty of tax treatment for non-capital LAC debt instruments and to create a level playing field for different entities within a banking group and different banking groups in relation to interest expenses deduction for LAC debt instruments, irrespective of whether such instruments are issued by an AI or its AOE or holding company. The major issues discussed by the Bills Committee are summarized in the ensuing paragraphs.

Potential abuse of loss-absorbing capacity instruments

15. Some members of the Bills Committee including Dr KWOK Ka-ki and Mr WU Chi-wai have expressed concern about whether AIs can utilize various financial arrangements (e.g. through holding LAC debt instruments issued by other AIs, purchasing LAC debt instruments issued by a subsidiary in the same banking group, etc.) to exploit the proposed profits tax deduction and stamp duty exemption. These members have further raised concern as to whether the proposed tax deduction and stamp duty exemption would incentivize an AI, which is still viable, to abuse the use of resolution in order to obtain capital resources.

16. The Administration has advised that the LAC Rules have prescribed restrictions on the sale and holding of LAC instruments by AIs, in particular for transactions between a subsidiary and its holding company (i.e. "back-to-back transactions"). If MA classifies an AI as a resolution entity, the AI has to issue external LAC instruments to external entities (such entities are confined to professional investors including FIs). If MA classifies an AI in a banking group as a material subsidiary, the AI can only issue internal LAC instruments to the resolution entity of the banking group, which is usually a holding company of the subsidiary. For intra-group transactions which involve back-to-back arrangements, the purchaser of internal LAC instruments (i.e. the holding company) has to meet external LAC requirements of its own. The holding company's holdings of internal LAC instruments issued by the material subsidiary need to be deducted from its resources for meeting its external LAC requirements. The purchase of a material subsidiary's LAC instruments by its holding company is a form of capital injection of the holding company to the material subsidiary. If the holding company or the material subsidiary purchases external LAC instruments issued by other banking groups, it has to make a corresponding reduction in its own capital. The corresponding deduction in the capital is to mitigate the risk of financial contagion. The deduction in LAC capital prevents holding companies and AIs from artificially

increasing their capital through holding of LAC instruments issued by their group companies or other banking groups.

The proposed profits tax treatment for loss-absorbing capacity debt instruments

17. Clause 8 of the Bill seeks to amend section 17A(1) of IRO by expanding the definition of RCS to include LAC debt instruments. 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) non-capital LAC debt instruments issued by AIs;
- (b) all LAC debt instruments issued by a LAC banking entity;⁶ and
- (c) all instruments issued by a non-Hong Kong incorporated AI under a LAC-equivalent requirement⁷ of a non-Hong Kong jurisdiction.

18. Clause 7 adds the proposed new sections 16(2)(ab) and 16(2AAB) to IRO to extend the profits tax treatment currently afforded to interest payable by FIs 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 Hong Kong holding company of an AI in respect of all LAC debt instruments issued by the AOE or clean Hong Kong holding company.

Definitions of the terms "fair value" and "regulatory capital security"

19. Clause 8 of the Bill also seeks to amend the definitions of the terms "fair value" and "fair value accounting" in section 17A(1) of IRO to encompass their application to RCS. The Bills Committee has enquired about the reasons for making the proposed amendments, whether the profits tax assessments of LAC debt instruments will be affected by fluctuations in the "fair value" of such

⁶ Under the proposed amendment to section 2(1) of the Inland Revenue Ordinance ("IRO"), a LAC banking entity means a 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.

⁷ 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.

instruments, and whether the computation of fair value of LAC debt instruments will be affected by the Inland Revenue (Amendment) (No. 7) Bill 2018,⁸ which covers, among others, amendments relating to fair value accounting.

20. The Administration has explained that the Bill amends the interpretation of the term "fair value" to align it with the text of the term used in International Financial Reporting Standards. The amendment will not introduce any material change to the meaning of the term. As regards the term "RCS", the definition is revised to relocate the word "security" to sub-paragraphs (a) and (b) in the definition as most of the LAC debt instruments are "instruments" rather than "security". The amended definition also includes the newly added non-capital LAC debt instruments of FIs (including all AIs), LAC debt instruments of Hong Kong AOE's and clean Hong Kong holding companies, and LAC debt instrument-equivalent of overseas FIs under the interpretation.

21. The Administration has advised that in general, under fair value accounting, all financial instruments will be measured at fair value. For RCSs, any fluctuations in fair value will be ignored in ascertaining the issuer's chargeable profits. If the security is issued to a specified connected person ("SCP") of the issuer, fluctuations in fair value of the security will also be ignored in ascertaining the SCP's chargeable profits. The Administration has confirmed that the Inland Revenue (Amendment) (No. 7) Bill 2018 will not change the application of sections 17C and 17D of IRO⁹ in respect of RCSs.

Effective date of the proposed interest expense deduction arrangement

22. The Bills Committee notes PricewaterhouseCoopers Limited's views that certain LAC debt instruments, in particular T2 capital instruments and non-capital LAC debt instruments, are purely debt securities despite their loss-absorbing capacity. As such, payments made under this kind of LAC debt instruments should be eligible for interest expense deduction both before and after enactment of the Bill.

23. The Administration has pointed out that T2 capital instruments and non-capital LAC debt instruments are not purely debt in nature. LAC debt instruments (including AT1 capital instruments, T2 capital instruments and non-capital LAC debt instruments) are hybrid in nature, i.e. while their legal form is debt-like, they have an equity-like loss absorbing feature. Their hybrid

⁸ The Inland Revenue (Amendment) (No. 7) Bill 2018 was introduced into LegCo at the meeting of 14 November 2018 and is under scrutiny by a Bills Committee.

⁹ Sections 17C and 17D of the Inland Revenue Ordinance (Cap. 112) relate to ascertaining profits in respect of an issuer and a specified connected person of the issuer of a regulatory capital security.

nature raises questions about their tax treatment. The Inland Revenue (Amendment) (No. 2) Ordinance 2016 has provided debt-like tax treatment to AT1 and T2 capital instruments issued by AIs under the regulatory capital regime. Similar amendments are proposed in the Bill to provide debt-like tax treatment for non-capital LAC debt instruments.

24. The Administration has pointed out that sums payable, in respect of T2 capital instruments, on or after 3 June 2016 (i.e. the commencement date of the Inland Revenue (Amendment) (No. 2) Ordinance 2016) are treated as interest by virtue of sections 16(2AA) and 17B of IRO and are eligible for deduction in accordance with section 16(1)(a). The relevant provisions are not applicable to sums payable, in respect of T2 capital instruments, before 3 June 2016. As for non-capital LAC debt instruments, section 6(b) of the proposed Schedule 47 to 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). The Administration has further advised that MA's current planning assumptions are that any classification of resolution entities and material subsidiaries under the LAC Rules will be made after the Bill has come into operation. On these assumptions, all sums payable in respect of such non-capital LAC debt instruments would be eligible for the proposed interest deduction.

Stamp duty exemption for the transfer of loss-absorbing capacity debt instruments

25. Schedule 9 to SDO 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 IRO. Clause 8 of the Bill seeks to amend section 17A(1) of IRO by expanding the definition of RCS to include LAC debt instruments. The provisions are to extend the current stamp duty exemption for transfers of AT1 and T2 capital instruments to all LAC debt instruments issued by the relevant AIs.

26. The Bills Committee has enquired about the reasons for exempting the transfer of LAC debt instruments from stamp duty. The Administration has advised that RCSs (including LAC debt instruments), which possess features of both debt and equity, are treated as debts by the international financial community. The Bill seeks to amend the definition of RCS under IRO to reflect this international practice. Currently, transfer of RCSs (consisting of AT1 and T2 capital instruments) which are treated as debt securities, is exempt from stamp duty under SDO. The amendment in the Bill will extend the stamp duty exemption to all LAC debt instruments.

Anti-avoidance provisions

27. Clauses 10 and 11 of the Bill seek 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 an SCP of the issuer of a RCS.

28. Some members of the Bills Committee have enquired whether the Bill includes anti-avoidance provisions on interest expenses deductions concerning (a) "back-to-back transactions"; and (b) transactions between an FI or a LAC banking entity and its associates.

29. Regarding "back-to-back transactions", the Administration has advised that if an AI issues internal LAC debt instruments to its holding company, the rules for interest expenses deduction will be as follows:

- (a) if the holding company is chargeable to tax in Hong Kong (i.e. not falling within the definition of SCP under section 17F of IRO), interest payable by the AI will be allowable for deduction without any restrictions; and
- (b) if the holding company is not chargeable to tax in Hong Kong (i.e. falling within the definition of SCP under section 17F of IRO), the basic rule is that the AI will not be eligible for interest deduction. However, if the holding company's funding for the purchase of the AI's internal LAC debt instruments is from the issuance of external LAC debt instruments or other debt instruments to a third party, interest payable by the AI will be allowable for deduction but the amount of deduction will be restricted to the sum payable by the holding company to the third party.

30. As regards transactions between an FI or a LAC banking entity and its associates, the Administration has advised that anti-avoidance measures are prescribed in section 17E of IRO, which sets out how profits shall be adjusted if the associates do not deal at arm's length in connection with RCS. The term

"conditions" in the proposed amended section 17E(1)(a) of IRO refers to the terms and conditions of commercial transactions.

Proposed amendments to the Bill

31. Both the Administration and the Bills Committee will not propose amendments to the Bill.

Resumption of Second Reading debate on the Bill

32. The Bills Committee has no objection to resuming the Second Reading debate on the Bill at the LegCo meeting of 30 January 2019.

Advice sought

33. Members are invited to note the deliberations of the Bills Committee.

Council Business Division 1
Legislative Council Secretariat
16 January 2019

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

Definition: Regulatory Capital Security ("RCS")

- Additional Tier 1 capital instrument
- Tier 2 capital instrument
- To add the following in the definition of RCS ①
 - Banking non-capital LAC debt instrument
 - A liability recognized as being eligible to count towards a non-HK equivalent of LAC requirement

- Treated as debt security
- Transfer of RCS is exempt from stamp duty

Tax Treatment

- **Interest income/gains/profits** arising from RCS are **treated as trading receipts** even if the moneys provided for the purchase are made available / transactions are effected outside HK
- **Interest expenses** arising from RCS are **allowable for deduction under profits tax**

Restrictions / Anti-Tax Avoidance

- **Fair value accounting cannot be used** in ascertaining the chargeable profits of RCS issuers (or its specified connected persons); and sums arising from conversion to equity / write-down or write-up of RCS would not be treated as trading receipts / deductible for tax purpose
- **Anti-avoidance provisions:**
 - a) Restrictions on interest deduction for sums paid to specified connected persons;
 - b) arm's length principle; and
 - c) separate enterprise principle.

- To add a new definition of "LAC banking entity" (an "HK affiliated operational entity" or a "clean HK holding company") ②
- To provide that a **LAC banking entity is subject to the same set of restrictions / anti-tax avoidance provisions** ③

Corporate Treasury Centre ("CTC") eligibility

- To provide that LAC banking entities, same as financial institutions, are **not** eligible to be qualifying CTCs ④

Major provisions of the Inland Revenue (Amendment) (No. 6) Bill 2018

- (a) Clause 3 amends section 2 of the Inland Revenue Ordinance (Cap. 112) ("IRO") to add the definitions of "banking LAC requirement" and "LAC banking entity" to that section. In particular, "LAC banking entity" is defined as a Hong Kong affiliated operational entity or clean Hong Kong holding company within the meaning of the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements — Banking Sector) Rules, that is required to meet a requirement in respect of loss-absorbing capacity ("LAC") under those Rules;
- (b) Clauses 4 and 5 amend sections 14D and 14F of IRO respectively so that a LAC banking entity is not eligible to be a qualifying corporate treasury centre for the purpose of profits tax concession;
- (c) Clause 6 amends section 15 of IRO to add new sections 15(1)(ib) and (lb) to deem the following sums as trading receipts –
 - (i) certain sums received by or accrued to a LAC banking entity by way of interest in respect of a regulatory capital security;
 - (ii) 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 regulatory capital security;
- (d) Clause 7 amends section 16 of IRO so that interest payable on money borrowed by a LAC banking entity by way of issuing a regulatory capital security is deductible for ascertaining chargeable profits;
- (e) Clause 8 amends section 17A of IRO to amend the definitions of "fair value" and "fair value accounting", and to expand the definition of "regulatory capital security" to include LAC debt instruments other than Additional Tier 1 capital instruments and Tier 2 capital instruments;
- (f) Clause 9 amends section 17D of IRO so that it applies to a connected person of an issuer of a regulatory capital security even if the connected person is chargeable to profits tax in respect of a sum payable in respect of the security;
- (g) Clause 10 amends section 17E of IRO to make it applicable to a LAC banking entity;

- (h) Clause 11 amends section 17F of IRO in consequence of the amendment made to section 17D of IRO; and
- (i) Clauses 12 amends section 89 of, and clause 14 adds Schedule 47 to, IRO to provide for transitional arrangements.

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

Membership list

Chairman Hon Kenneth LEUNG

Members Hon WONG Ting-kwong, GBS, JP
Hon WU Chi-wai, MH
Dr Hon KWOK Ka-ki
Hon Dennis KWOK Wing-hang
Hon Christopher CHEUNG Wah-fung, SBS, JP
Hon CHAN Chun-ying, JP

(Total : 7 members)

Clerk Ms Connie SZETO

Legal Adviser Miss Linda CHAN

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

List of organizations from which the Bills Committee has received views

1. The Hong Kong Association of Banks
2. PricewaterhouseCoopers Limited