



Inland Revenue Department
Hong Kong

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 27 (REVISED)

PROFITS TAX

STOCK BORROWING AND LENDING

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the law as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

These notes replace those issued in November 1996.

CHU Yam-yuen
Commissioner of Inland Revenue

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INTRODUCTION

This Practice Note was first issued in November 1996, and serves to outline the Profits Tax treatment of stock borrowing and lending transactions which come within the scope of section 15E of the Inland Revenue Ordinance (the Ordinance). The current revision reflects changes in the definition of certain terms, but the Department's approach in applying section 15E remains the same.

2. Section 15E was added to the Ordinance by the Inland Revenue (Amendment) (No. 2) Ordinance 1994 and came into effect on 8 July 1994. On the same date, the Stamp Duty (Amendment) (No. 2) Ordinance 1994 also came into effect and extended the scope of the relief from Stamp Duty provided under the Stamp Duty Ordinance (the SDO) in respect of stock borrowing and lending transactions. Stamp Office Interpretation and Practice Notes No. 2 (Revised) explains how the Collector of Stamp Revenue interprets the relevant SDO provisions. As several of the terms used in section 15E of the Ordinance are defined by reference to the corresponding terms in the SDO, this Practice Note should be read and construed in conjunction with the Stamp Office Practice Notes.

3. It should be noted that the ambit of section 15E has been extended since it was introduced. Originally the section only provided Profits Tax relief in respect of transactions which also qualified for Stamp Duty relief, namely those concerning Hong Kong stock the sale and purchase of which in Hong Kong are subject to the rules and practices of the Stock Exchange of Hong Kong. With the enactment of the Inland Revenue (Amendment) (No. 4) Ordinance 1996, section 15E was amended to also provide relief, with application to the year of assessment commencing on 1 April 1996 and subsequent years of assessment, for transactions involving "specified securities", i.e. securities specified by the Commissioner in accordance with the definition of the term in section 15E(8) of the Ordinance.

TRANSACTIONS TO WHICH SECTION 15E APPLIES

4. In broad terms, section 15E is concerned with what are in substance stock loans, even though transactions are involved which have the effect of

transferring the legal title to stock between the relevant parties. In this regard, the Department accepts that there are two main categories of transactions which come within the scope of section 15E, namely, stock borrowing and lending transactions (SBLTs) and repurchase transactions (Repos). Each category is discussed in further detail below.

SBLTs

5. An SBLT is typically initiated by a person who seeks to borrow stock (the borrower) from a person who has such stock (the lender). The borrower is generally either (i) a short seller (see note¹) who has to deliver stock sold short to a purchaser (or a securities dealer acting on behalf of its customer who has sold short); (ii) a securities dealer covering “fails” to deliver stock by customers; or (iii) an intermediary, typically a securities dealer, who would on-lend the stock borrowed (e.g. the borrower locates stock and on-lends it to a person who could not locate it directly; in other words, the initial borrower “intermediates” between the initial lender and the subsequent borrower).

6. Under an SBLT, the lender transfers the legal and beneficial ownership of the borrowed stock to the borrower. The lender loses legal ownership rights (including the right to vote) in exchange for collateral from the borrower (usually cash, but can be debt or equity securities). Title to the collateral passes from the borrower to the lender. The borrower agrees to return stock equivalent to the borrowed stock to the lender upon the lender’s demand or within a certain period of time, at which time the lender returns the collateral to the borrower. The lender remains entitled to the economic benefits (and risk of loss) of the stock during the period the stock is lent (i.e. the “borrowing period”). If either party becomes insolvent, the other party may retain the borrowed stock or collateral as the case may be.

7. Various payments and distributions of property can be made under an SBLT. The lender generally receives a fee (“borrowing fee”) from the borrower in respect of the borrowed stock. In addition, if any interest, dividend or other distribution is made in respect of the borrowed stock during

¹ By virtue of s.170 of the Securities and Futures Ordinance (Cap. 571) which requires a seller of securities to have a presently exercisable and unconditional right to vest the securities in the purchaser of them, a short seller must first obtain a stock borrowing facility by entering into a stock borrowing and lending agreement with a stock lender.

the borrowing period, the lender receives from the borrower the distribution (or identical property) or a compensatory payment, sometimes called a “manufactured dividend” if paid in place of a dividend, equal to the value of the distribution.

8. In the other direction, if the borrower provides cash to the lender as collateral, the lender will pay the borrower a so-called “loan rebate fee” which is generally calculated with reference to published inter-bank interest rates. If the borrower instead furnishes non-cash collateral to the lender, then, depending upon the agreement between the parties, the lender will pay the borrower compensatory payments in respect of distributions made in relation to the non-cash collateral (or pass on the actual distributions) or the borrower may substitute cash for the non-cash collateral prior to each distribution date so that the borrower receives the distributions directly.

9. Finally, payments of cash or transfers of non-cash collateral can be made between the borrower and the lender (in either direction) to reflect variations during the borrowing period in the value of the borrowed stock. Such payments/transfers are to ensure that the value of the collateral held by the lender continues to represent the same proportion of the value of the borrowed stock when the collateral was originally provided to the lender.

Repos

10. In economic terms Repos are very similar to SBLTs. A Repo is typically initiated by a person (the seller) who has stock in the form of equity or debt securities but needs cash agreeing to sell the stock to a person (the buyer) who has the cash. At the same time the buyer agrees to sell equivalent stock to the seller at a later date, or on demand, at a price which is specified or is to be determined using a specified basis of calculation. A “Reverse Repo” is essentially the same, but is initiated by a person (the buyer) who has cash and is willing to exchange it for securities. The seller in a Reverse Repo also agrees to repurchase equivalent stock from the buyer. Repos and Reverse Repos are entered into for purposes of (i) liquidity management (i.e. the exchange of cash for stock for a temporary period); (ii) intermediation; and (iii) at times, to cover short sales or “fails” to deliver by customers.

11. As with an SBLT, the seller transfers the legal and beneficial ownership of the debt or equity securities to the buyer. If either party becomes insolvent, the other party may retain the purchased stock or cash, as the case may be.

12. Reflecting the practice with SBLTs, the seller receives from the buyer the economic benefit of any distribution made in respect of the stock prior to repurchase, i.e. during the borrowing period. Upon repurchase, the initial seller pays the initial buyer the repurchase price in cash in exchange for the stock. The repurchase price includes a pre-determined premium, usually referred to as a “price differential”, which is generally based on the purchase price paid by the initial buyer and calculated with reference to published inter-bank interest rates. Other factors which may affect the amount of the price differential include the desirability or need for the securities involved, and whether the securities are scripless or physical (an “inconvenience payment” may be charged in the case of physical securities).

13. The cash paid by the buyer to the seller in exchange for stock under a Repo can be likened to the payment of collateral in the context of an SBLT. The cash paid may subsequently be increased or decreased to maintain the ratio of the purchase price paid to the market value of the stock. For the same purpose, “margin securities” may be transferred between the seller and the buyer (in either direction) during the term of the Repo. Such payments of cash and transfers of securities are analogous to the increase or decrease of collateral in the case of an SBLT.

Conditions for relief

14. Section 15E only has application where conditions to the following effect laid down in section 15E(1) are satisfied:

- (a) the “borrowed stock” obtained under a stock borrowing and lending agreement (which may be in the form of a Repo agreement) was used by the borrower (buyer in the case of a Repo) for one or more than one specified purpose (see paragraph 18 below), and has effected a “stock return” as defined in section 19(16) of the SDO;

- (b) the borrower either passed on any distribution made in respect of the borrowed stock to the lender or provided the lender with a compensatory payment of equal value (e.g. the so-called “manufactured dividend”);
- (c) the lender did not dispose of the right to receive any part of the total consideration payable by the borrower under the stock borrowing and lending agreement;
- (d) both the borrower and lender were dealing with each other at arm’s length; and
- (e) the lender did not enter into the stock borrowing with the purpose, or main purpose, of avoiding or deferring the inclusion of any amount in profits in respect of which the lender is chargeable to Profits Tax.

Types of securities

15. As was mentioned in paragraph 3 above, relief under section 15E was originally only available in respect of transactions which also qualified for relief under the SDO, i.e. those involving “Hong Kong stock the sale and purchase of which in Hong Kong are subject to the rules and practices of the recognized exchange company that operates the relevant stock market”. However, with effect from the year of assessment commencing on 1 April 1996, relief under section 15E was extended to also apply in respect of transactions involving “specified securities”. The expression is defined in the section in the following terms-

““specified securities” means any of the following, not being Hong Kong stock the sale and purchase of which in Hong Kong are subject to the rules and practices of a recognized stock market-

- (a) any shares, stocks, debentures, loan stocks, funds, bonds or notes of or issued by any body, whether corporate or unincorporate, or any government or local government authority, or any other similar investment of any description;

- (b) any units under a unit trust scheme;
- (c) any right, option or interest in or in respect of any security referred to in paragraph (a) or (b),

which the Commissioner may specify in writing, either generally or in any particular case, for the purposes of this section.”

16. Pursuant to the terms of the definition, on 30 August 1996 the Commissioner specified, by means of Departmental Interpretation and Practice Notes No. 26, that where associated parties are not involved securities falling into the following categories are specified securities for the purposes of section 15E-

- (i) any debt or equity security listed on a stock exchange in Hong Kong or any other stock exchange or over-the-counter market recognized for the purposes of this paragraph by the Commissioner;
- (ii) any unlisted debt issued to third parties or guaranteed to third parties by listed companies (including affiliates owned 50% or more by listed companies);
- (iii) any unlisted sovereign debt (including, for this purpose, government agency debt, multilateral agency debt and debt guaranteed by multilateral agencies or sovereign governments); and
- (iv) any unlisted debt or equity securities issued pursuant to a private placement authorized by the Hong Kong Securities and Futures Commission or a similar supervisory body in another jurisdiction.

17. The categories of specified securities may change from time to time. Accordingly, reference should be made to Practice Notes No. 26 (Revised) to ascertain the current position, or to the Department if there is any doubt in relation to a particular situation. The Practice Note also provides information concerning the circumstances where associated parties are considered to be involved.

Specified purposes

18. For the purposes of section 15E, the term “specified purpose” is defined in section 15E(8) to have, subject to section 15E(9), the same meaning as in the SDO. The SDO definition is contained in section 19(16) and is as follows:

““specified purpose”, in relation to the borrowing of stock by any person, means-

- (a) the settling of a sale of Hong Kong stock wherever effected, whether by the person himself or another person;
- (b) the settling of a future sale of Hong Kong stock, whether agreed or not when such stock borrowing is effected and whether by the person himself or another person;
- (c) the replacement, in whole or in part, of Hong Kong stock obtained by the person under another stock borrowing;
- (d) the on-lending of the stock borrowed to another person who effects a stock borrowing in respect of such stock on-lent; or
- (e) such other purpose as the Collector may, in writing, allow either generally or in any particular case.”

Section 15E(9) widens the meaning of the definition for Profits Tax purposes by providing that, so far as is relevant, any reference to Hong Kong stock in the SDO definition is to be construed as including a reference to specified securities.

19. To cater for the purpose for which the majority of Repos are entered into, the Collector accepts, under the authority provided in paragraph (e) of the SDO definition, that stock obtained by a buyer for the purpose of liquidity management is for a “specified purpose” (see paragraphs 40 to 42 of Stamp Office Interpretation and Practice Notes No. 2 (Revised)).

COLLATERAL SECURITIES

20. As was pointed out earlier, the provision of collateral is an integral part of SBLTs (from the borrower to the lender) and Repos (from the buyer to the seller). While cash is typically used in the case of Repos, SBLTs may involve the transfer of stock from the borrower to the lender as collateral, with the borrower remaining entitled to the economic benefits of the stock, and the re-transfer of this stock back to the borrower at the end of the borrowing period. Provided that this is the case and the SBLT itself is for a specified purpose, then the transfers of the collateral (i.e. both from and back to the borrower) and the passing on of any distributions or making of any compensatory payments in respect of the collateral will be treated for tax purposes in an identical manner as those in relation to the original SBLT transaction (i.e. the stock loan which necessitated the stock collateral in the first place). In short, the provision of collateral securities to the lender and the subsequent re-transfer to the borrower can be regarded as constituting a reverse SBLT which falls within the provisions of section 15E.

TAXATION TREATMENT

21. The Profits Tax treatment of the more common property transfers and payments associated with stock borrowing and lending agreements is discussed in the following paragraphs.

Borrowed stock

22. Section 15E(2) sets out the position of the lender (seller in the case of a Repo), other than in respect of the borrowing fee (see paragraph 25 below), under a stock borrowing and lending agreement in relation to the transactions by which stock is transferred from the lender to the borrower (from the seller to the buyer in the case of a Repo) and subsequently the transactions by which stock of the same description or any reasonable equivalent is transferred back. In essence, the subsection provides that, to the extent that a stock return is made in respect of the borrowed stock, the lender is treated as if the stock borrowing and stock return had not been made and as having held the borrowed stock during the relevant borrowing period.

23. Accordingly, the lender is to disregard any chargeable profit (apart from the borrowing fee) which would otherwise arise in respect of both the disposal of the stock to the borrower and the subsequent re-acquisition. It also follows that a lender who normally values stock for accountancy purposes at current market value should continue to value the borrowed stock in this way during the borrowing period. As such, where the borrowing period bridges the end of an accounting period the difference between the opening value and the value at the end of the accounting period should be recorded by the lender, subject to source principles, as a profit or loss, as the case may be, for Profits Tax purposes.

24. As regards the borrower, the disposal of borrowed stock for a specified purpose in the normal course of a business carried on in Hong Kong will give rise to a profit or loss. The subsequent disposal of replacement stock to the lender will similarly give rise to a profit or loss. In calculating the profit or loss, section 15E(5) provides in effect that the market value of the borrowed stock at the time of the borrowing is to be taken both as the cost of the borrowed stock and as the sale price of the replacement stock. Subject to source principles, the profits will be taxed or losses allowed.

Borrowing fees

25. The fee payable by the borrower to the lender in respect of a stock borrowing is in the nature of a service fee and is treated as income in the hands of the lender and as expense for the borrower. General principles determine whether the fee is chargeable or deductible for Profits Tax purposes, as the case may be.

Actual distributions in respect of borrowed stock

26. Section 15E(3) provides in effect that where a lender receives from a borrower in relation to borrowed stock a distribution, right, option or identical property (i.e. the “distribution” is passed on by the borrower to the lender), the lender is treated for tax purposes as if the distribution had been received directly by the lender in respect of a continued holding of the borrowed stock. Accordingly, the nature of the distribution will determine its taxability. For example, a dividend would be exempt, whilst the chargeability of interest would depend on matters such as its source and whether special provisions of

the Ordinance apply to the recipient. The tax treatment of the amount received by the lender therefore is not affected by the fact that it has come other than from the issuer of the stock; it is treated as having the same nature and source for tax purposes as the original distribution.

27. With regard to the borrower, where a distribution is received in respect of borrowed stock (e.g. if the borrower is still holding the borrowed stock at the time a distribution is made) and it is then passed on to the lender (or a payment of equal value is made to the lender), the receipt and subsequent action are in effect ignored for Profits Tax purposes. In other words, as far as the borrower is concerned, receipt of the actual distribution does not give rise to any chargeable profit and the subsequent passing on of it, or payment of equal value, to the lender does not create an allowable deduction.

Compensatory payments

28. Section 15E(4) applies where the borrower has not received the actual distribution and has therefore made a payment of equal value (a compensatory payment) to the lender. This is the more likely circumstance as a borrower would not generally continue to hold the borrowed stock, but would instead deliver it to a purchaser in respect of a short sale or on-lend it to a subsequent borrower. This subsection again puts the lender in the same taxation position as would have been the case if the lender had retained ownership of the borrowed stock and received the original distribution. The nature of the original distribution will determine the tax treatment of the compensatory payment in the hands of the lender.

29. Section 15E does not address the position of the borrower in relation to compensatory payments. Accordingly, the question of deductibility is determined under sections 16 and 17 of the Ordinance, i.e. the amount will qualify for deduction if it can be characterized as an outgoing or expense incurred by the borrower in the production of profits which are chargeable to Profits Tax and is not of a capital nature.

30. The above principles also apply in relation to compensatory payments made by the lender to the borrower in respect of a reverse SBLT, i.e. for distributions on collateral securities provided by the borrower to the lender under the terms of the stock borrowing and lending agreement.

Loan rebate fees and price differentials

31. A loan rebate fee in relation to an SBLT is payable by a lender to a borrower when cash collateral is given by the borrower to the lender in respect of the borrowed stock. The fee is generally calculated with reference to the amount of cash involved, inter-bank interest rates and the length of time the cash collateral is held by the lender. Similarly, a price differential in relation to a Repo (included in the repurchase price paid by the initial seller to the initial buyer) is usually calculated with reference to the purchase price paid by the initial buyer, inter-bank interest rates and the length of time the cash is held by the initial seller. Thus, rebate fees and price differentials are considered to be, in substance, interest and are treated accordingly.

32. Reflecting the conditions governing the deductibility of interest laid down in section 16(2) of the Ordinance, a loan rebate fee or price differential paid by a lender to an overseas counterparty not carrying on business in Hong Kong will not generally qualify for deduction unless the recipient is an overseas financial institution as defined in section 16(3). However, in practice the Department will accept that where the recipient is acting as a principal and is a securities dealing and underwriting firm regulated in at least one overseas jurisdiction by a supervisory body similar to the Hong Kong Securities and Futures Commission, it can be recognized as an overseas financial institution for the purposes of sections 15E and 16(2). Recognition will also be granted if the recipient is an affiliate owned 50% or more, directly or indirectly, by such a securities firm.

ASSESSMENTS

33. Where a person has entered into a stock borrowing and lending agreement and at the close of the year of assessment not all transactions under the agreement have taken place (e.g. a stock return has not been made because the borrowing period has not finished), the Assessor can, by virtue of section 15E(6), raise the assessment for the year concerned on the basis that section 15E is applicable. If it is subsequently found that the section is not applicable, the assessment can be adjusted accordingly under section 15E(7).

ACCOUNTING TREATMENT

34. The taxation treatment of property transfers and cash flows associated with stock borrowing and lending agreements reflects the Department's understanding of generally accepted accounting practice in relation to such agreements. Briefly, the Department understands that the following conventions would generally apply:

- the lender (seller in the case of a Repo) continues to reflect the borrowed stock (securities subject to repurchase in the case of a Repo) as an asset on its balance sheet;
- the borrower (buyer in the case of a Repo) continues to reflect the collateral given to the lender as an asset on its balance sheet;
- if either the borrowed stock or collateral is normally valued at current market value, then the party reflecting the asset on its balance sheet will include either income or loss, as the case may be, in its profit and loss statement in respect of any difference in values between the beginning and end of the period;
- if actual distributions are received by the borrower and passed on to the lender (as opposed to the borrower making compensatory payments in respect of distributions not received), the receipt and passing on of such distributions will not be reflected in the borrower's profit and loss statement;
- compensatory payments in respect of distributions are reflected as expenses in the profit and loss statement of the borrower and as income in the profit and loss statement of the lender;
- borrowing fees are reflected as expenses in the profit and loss statement of the borrower and as income in the profit and loss statement of the lender; and

- loan rebate fees (price differential payments in the case of a Repo) are reflected as interest expenses in the profit and loss statement of the lender and as interest receipts in the profit and loss statement of the borrower.

If the accounting treatment in any particular case differs from the general understanding set out above, and the matter is not self-evident from the notes to the accounts, this must be drawn to the Assessor's attention in the tax computation submitted.

35. This Practice Note has been prepared with regard to the fact that the relevant legislation was introduced with a view to promoting the development of Hong Kong as a major financial centre. The positions taken by the Department are generally intended to be consistent with the substance of the transactions involved and their treatment within the industry. Consequently, this Practice Note should not impose undue restrictions on the parties ordinarily engaged in SBLT and Repo businesses. At the same time, the Department will not accept that its contents can in any way restrict action to counter tax avoidance. This Practice Note will be reviewed in the light of experience. Should situations encountered so dictate, changes will be effected.