



Inland Revenue Department

The Government of the Hong Kong Special Administrative Region
of the People's Republic of China

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 53 (REVISED)

TAX TREATMENT OF REGULATORY CAPITAL SECURITIES

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 February 2017.

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Commissioner of Inland Revenue

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INTRODUCTION

Relevant legislation

The Inland Revenue (Amendment) (No. 2) Ordinance 2016 (the 2016 Amendment Ordinance) was enacted on 3 June 2016 to treat regulatory capital securities (RCSs) as debt securities. RCS was defined therein to mean an Additional Tier 1 (AT1) capital instrument or a Tier 2 (T2) capital instrument issued by financial institutions for the purposes of the Banking (Capital) Rules (Cap. 155L) or of the equivalent laws or regulatory requirements of another member jurisdiction of the Basel Committee on Banking Supervision (the Basel Committee).

2. The Inland Revenue (Amendment) Ordinance 2019 (the 2019 Amendment Ordinance) was enacted on 15 February 2019 to expand the definition of RCS to include loss-absorbing capacity (LAC) debt instruments issued by financial institutions or LAC banking entities for the purposes of the Financial Institutions (Resolution) Ordinance (Cap. 628) (FIRO) and the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements—Banking Sector) Rules (Cap. 628B) (LAC Rules).

3. This Departmental Interpretation and Practice Note (DIPN) sets out the Department's views and practices on the application of sections 17A to 17G of the Inland Revenue Ordinance (Cap. 112) (IRO) which relate to RCS.

CAPITAL ADEQUACY AND LOSS-ABORBING CAPACITY

Basel III capital adequacy requirements

4. The Basel III capital adequacy requirements are the minimum standards promulgated by the Basel Committee, under which financial institutions must hold certain amount of regulatory capital expressed as a percentage of their total risk-weighted assets. The Basel III requirements have been gradually implemented in Hong Kong and 27 other member jurisdictions of the Basel Committee since 2013. The Banking Ordinance (Cap. 155) and the Banking (Capital) Rules are the relevant local legislation.

Loss-absorbing capacity requirements

5. Recognizing the importance of both addressing “too big to fail” phenomenon observed in the financial crisis in 2007 and enhancing the resilience of the local financial system, Hong Kong has implemented the international standards set out by the Financial Stability Board in its *Key Attributes of Effective Resolution Regimes for Financial Institutions* through the enactment of the FIRO in June 2016. The main provisions of the FIRO came into force on 7 July 2017. The LAC Rules which were made under section 19 of the FIRO came into operation on 14 December 2018.

6. The FIRO establishes a resolution regime for financial institutions in Hong Kong with systemic importance. A bail-in stabilization option, subject to the requisite conditions being met, may be initiated for a non-viable financial institution to write down or convert certain liabilities into equity, thereby absorbing the loss and restoring the financial institution to viability. For effective application of the bail-in stabilization option, the LAC Rules provide that a financial institution, its holding company or its affiliated operational entity, which in each case is incorporated in Hong Kong, may be classified as a “resolution entity”.

7. A resolution entity must meet a LAC requirement with external LAC instruments that are issued to an entity outside its resolution group. The LAC Rules also provide that a financial institution, its holding company or its affiliated operational entity, which in each case is incorporated in Hong Kong, that is in a resolution group but is not itself a resolution entity may be classified 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.

Features of regulatory capital securities

8. Financial institutions and LAC banking entities may seek to comply with the Basel III requirements or LAC requirements, whenever appropriate, by strengthening their capital base or loss-absorbing capacity through, among other means, issuing RCSs to raise funds. Unlike Common Equity Tier 1 (CET1) capital instruments which are equity in nature, RCSs are hybrid in nature. While their legal form is debt-like, RCSs 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 financial institutions. Their hybrid nature raises questions about their tax treatment, in particular whether they are eligible for debt-like tax treatment under the IRO.

9. Prior to the enactment of the 2016 Amendment Ordinance, AT1/T2 instruments were not regarded as debt instruments under the IRO, and their distributions were not deductible for profits tax purposes. Regarding LAC debt instruments, they were issued only after the imposition of LAC requirements.

TAX FRAMEWORK FOR REGULATORY CAPITAL SECURITIES

The framework

10. The 2016 Amendment Ordinance and the 2019 Amendment Ordinance provide that a RCS is to be treated as a debt security. Generally, any payments under a RCS which are not repayments of principal are to be treated as interest for both deduction and taxation purposes. These include coupon payments, premium paid and discount given.

11. Specific anti-avoidance provisions were enacted to prevent financial institutions and LAC banking entities from issuing RCSs for tax avoidance purposes. Chargeable profits from a RCS transaction between an issuer of the RCS and its associates will be determined by reference to the amount of profits that would have accrued had the same transaction been carried out, at arm's length terms, between persons who are not associates (i.e. the arm's length principle). There are also restrictions and conditions on deduction for sums payable in respect of a RCS issued to or for the benefit of, or held by or for the benefit of, a specified connected person (SCP) of the issuer. As an anti-abuse measure, in ascertaining the chargeable profits of the Hong Kong branch of a financial institution, whose head office is outside Hong Kong, with capital raised through the issue of RCSs, profits will be attributed as if the Hong Kong branch and other parts of the financial institution were separate enterprises (i.e. the separate enterprises principle), and the amount of deduction allowable for costs and expenses relating to RCSs is not to exceed the amount that would have been incurred by the Hong Kong branch on this basis (i.e. on the basis that the Hong Kong branch has an appropriate combination of equity and loan capital).

The main provisions

12. The main provisions of the 2016 Amendment Ordinance and the 2019 Amendment Ordinance relating to RCSs are as follows:

- (a) Section 17A defines RCS and terms for other related sections.
- (b) Section 17B provides that for the purposes of Part 4 of the IRO, a RCS is to be treated as a debt security and a payment in respect of the RCS (other than a repayment of the paid-up amount) is to be treated as interest payable on the RCS. This is subject to sections 17C to 17G.
- (c) Sections 17C(2) and 17D(2) provide that, for the issuer of the RCS and the issuer's SCP, as defined by section 17D(5), by whom or for whose benefit the RCS is held, fair value accounting of the RCS is not permitted for tax purposes in relation to the RCS or part of the RCS.
- (d) Section 17C(3) and (4) and section 17D(3) and (4) provide that, for the issuer and the issuer's SCP, as defined by section 17D(5), a sum representing the paid-up amount of a RCS on a conversion, write-down or subsequent write-up of the RCS arising as a result of the issuer hitting a regulatory trigger or nearing insolvency is not to be treated as a trading receipt and is not deductible for tax purposes.
- (e) Section 17E provides that the chargeable profits from a transaction in connection with RCS between a financial institution or LAC banking entity and its associate will be determined by reference to the amount of profits that would have accrued had the same transaction been carried out on terms that would have been made between parties who are not associates.
- (f) Section 17F sets out, in relation to a RCS issued to, held by or issued or held for the benefit of a SCP of the issuer, as defined by section 17F(9A), the conditions that must be met in order for a payment in respect of the RCS to be deductible.

- (g) Section 17G sets out the basis on which the profits attributable to a Hong Kong branch of a non-resident financial institution with capital raised through the issue of RCS are to be determined. In essence, profits are to be attributed as if the Hong Kong branch were a distinct and separate enterprise.
- (h) Section 15(1)(ib) provides that sums received by or accrued to a LAC banking entity by way of interest in respect of a RCS that arises through or from the carrying on by the entity of its business in Hong Kong are deemed to be trading receipts.
- (i) Section 15(1)(j) and (k) as amended provides that sums received by or accrued to a person carrying on a trade, profession or business in Hong Kong by way of gains or profits arising in or derived from Hong Kong from the sale or other disposal, or on the redemption of a RCS are deemed to be trading receipts. For a person other than a corporation, only such gains or profits in respect of the funds of the trade, profession or business are deemed to be trading receipts.
- (j) Section 15(1)(l) as amended provides that sums received by or accrued to a financial institution by way of gains or profits arising through or from the carrying on by the financial institution of its business in Hong Kong from the sale or other disposal, or on the redemption of a RCS are deemed to be trading receipts.
- (k) Section 15(1)(la) provides that sums received by or accrued to a corporation (other than a financial institution), by way of gains or profits arising through or from the carrying on in Hong Kong by the corporation of its intra-group financing business, from the sale or other disposal, or on the redemption of a RCS are deemed to be trading receipts.
- (l) Section 15(1)(lb) provides that sums received by or accrued to a LAC banking entity by way of gains or profits arising through or from the carrying on by the entity of its business in Hong Kong from the sale or other disposal, or on the redemption of a

RCS are deemed to be trading receipts.

- (m) Section 15(1C) provides that the deemed trading receipts provisions under section 15(1)(f), (g), (i), (ia), (j), (k), (l) and (la) apply, subject to sections 17B to 17G, in relation to a RCS.
- (n) Section 15(1D) provides that the deemed trading receipts provisions under section 15(1)(ib) and (lb) apply, subject to sections 17B to 17F, in relation to a RCS.
- (o) Section 16(2)(ab) allows deduction of interest if the money has been borrowed by a LAC banking entity by way of issuing a RCS.
- (p) Section 16(2AA) provides that deduction of interest payable by a financial institution in respect of a RCS issued by the financial institution is subject to sections 17B to 17G.
- (q) Section 16(2AAB) provides that deduction of interest payable by a LAC banking entity in respect of a RCS issued by the entity is subject to sections 17B to 17F.
- (r) Schedules 6 and 16 as amended clarify that the tax reliefs under sections 14A and 26A do not apply to a RCS whereas the tax exemption under section 20AC applies to it.
- (s) Schedule 36 provides for transitional matters in respect of the 2016 Amendment Ordinance which came into operation on 3 June 2016.
- (t) Schedule 47 provides for transitional matters in respect of the 2019 Amendment Ordinance which came into operation on 15 February 2019.
- (u) Rules 3 and 5 of the Inland Revenue Rules (Cap. 112A) are amended as a result of the introduction of section 17G under the 2016 Amendment Ordinance.

REGULATORY CAPITAL SECURITIES

Issuers of RCSs

13. In order to fulfil the Basel III capital adequacy requirements, financial institutions may issue AT1/T2 instruments to raise capital. Regarding the LAC requirements, a resolution strategy may be devised for any financial institution within scope. Depending on the circumstances, the preferred strategy may be for LAC debt instruments (i.e. RCSs) to be issued by a Hong Kong incorporated affiliated operational entity or a Hong Kong incorporated holding company of a Hong Kong incorporated financial institution, in addition to or in the stead of the financial institution.

14. The affiliated operational entity or holding company which falls within the meaning of “LAC banking entity” as defined in section 2 is entitled to receive the debt-like tax treatment on RCS which was previously only afforded to financial institutions prior to the enactment of the 2019 Amendment Ordinance. The term “LAC banking entity” is defined to mean:

- (a) an HK affiliated operational entity, as defined by rule 2(1) of the LAC Rules, that is required to meet a banking LAC requirement under the Rules; or
- (b) a clean HK holding company, as defined by rule 2(1) of the LAC Rules, that is required to meet a banking LAC requirement under those Rules.

The term “banking LAC requirement” means a LAC requirement as defined by rule 2(1) of the LAC Rules.

Covered securities

15. The term “regulatory capital security” is currently defined in section 17A(1) to mean:

- (a) a security that qualifies or has qualified as an AT1 instrument, and forms or formed a component of Additional Tier 1 capital, for the purposes of the Banking (Capital) Rules or of the

equivalent laws or regulatory requirements of another member jurisdiction of the Basel Committee;

- (b) a security that qualifies or has qualified as a T2 instrument, and forms or formed a component of Tier 2 capital, for the purposes of the Banking (Capital) Rules or of the equivalent laws or regulatory requirements of another member jurisdiction of the Basel Committee;
- (c) an instrument issued by a financial institution that qualifies or has qualified as a banking non-capital LAC debt instrument and forms or formed a component of banking loss-absorbing capacity for the purposes of the LAC Rules;
- (d) an instrument issued by a LAC banking entity that qualifies or has qualified as a banking LAC debt instrument and forms or formed a component of banking loss-absorbing capacity for the purposes of the LAC Rules; or
- (e) in relation to an entity established or incorporated outside Hong Kong, an instrument that is not a security referred to in subparagraph (a) or (b) above, and constitutes a liability that is recognized in the way as described in paragraph (c) of the definition of loss-absorbing capacity in rule 2(1) of the LAC Rules.

16. Section 17A(1) further provides the definition for each type of RCS:

- (a) AT1 instrument means a capital instrument that qualifies as Additional Tier 1 capital under Schedule 4B to the Banking (Capital) Rules, or under the equivalent laws or regulatory requirements of another member jurisdiction of the Basel Committee;
- (b) T2 instrument means a capital instrument that qualifies as Tier 2 capital under Schedule 4C to the Banking (Capital) Rules, or under the equivalent laws or regulatory requirements of another member jurisdiction of the Basel Committee;

- (c) banking LAC debt instrument means a LAC debt instrument as defined by rule 2(1) of the LAC Rules;
- (d) banking non-capital LAC debt instrument means a non-capital LAC debt instrument as defined by rule 2(1) of the LAC Rules.

17. In effect, RCSs are restricted to the following instruments:

- (a) qualifying AT1/T2 instruments issued by a financial institution incorporated in Hong Kong or another member jurisdiction of the Basel Committee;
- (b) qualifying LAC debt instruments, other than AT1/T2 instruments under subparagraph (a), issued by a financial institution or a LAC banking entity incorporated in Hong Kong; and
- (c) in relation to an entity established or incorporated outside Hong Kong, any instruments, other than those referred to in subparagraph (a), that recognized as being eligible to count towards a requirement under a regulatory regime in a non-Hong Kong jurisdiction that corresponds to the LAC requirements in Hong Kong.

Excluded securities

18. Relevant instruments with terms and conditions providing for write-down or conversion into ordinary shares to absorb losses in going concern (for AT1 instruments), at the point of non-viability of the issuer (for both AT1 and T2 instruments) or upon initiation of a bail-in stabilization option for a non-viable financial institution (for LAC debt instruments) are RCSs under section 17A and will be given debt-like tax treatment. However, the debt-like tax treatment is not intended to cover RCSs with essentially equity-like features, even though they may be considered as bona fide regulatory capital. Therefore, it is necessary to exclude instruments with equity returns (i.e. distributions dependent to any extent on the results of the business of the issuer of the instruments), or those subject to contractual conversion into ordinary shares after a certain period of time at the issuer's option or otherwise. Those excluded instruments will not be treated as debt securities for both deduction and taxation purposes.

19. Section 17A(2) stipulates that RCS does not include:
- (a) a share;
 - (b) any debt instrument the terms and conditions of which provide for the issuer of the instrument converting, or having an option to convert, the instrument into a CET1 capital instrument of the issuer or any other corporation after a certain period of time; or
 - (c) any debt instrument –
 - (i) that carries a contractual right to any distribution or redemption payment that depends to any extent on the results of the business of the issuer of the instrument or of any part of that business; or
 - (ii) that provides discretion to the issuer of the instrument to make any distribution or redemption payment that depends to any extent on the results of the business of that issuer or of any part of that business.

Under section 17A(3), a debt instrument does not fall within subparagraph (c) above by reason only that the terms and conditions of the instrument provide for the reduction in distribution or redemption payment if the results of the business of the issuer of the instrument, or of any part of that business, worsen.

Example 1

Bank-HK issued Perpetual Mandatorily Convertible Capital Notes of US\$300m which qualified as AT1 instruments under Schedule 4B to the Banking (Capital) Rules. They would be mandatorily converted into Bank-HK's ordinary shares if they were not redeemed within 8 years of the issue date, based on the prevailing market price of the shares.

The Perpetual Mandatorily Convertible Capital Notes would be excluded from the definition of RCS under section 17A(2)(b) since Bank-HK could convert the Capital Notes into ordinary shares after a certain period of time (i.e. conversion would take place even though

in situations not falling within section 1(k) and (q) of Schedule 4B to the Banking (Capital) Rules).

Example 2

Bank-HK issued Redeemable Preference Shares of US\$500m which qualified as T2 instruments under Schedule 4C to the Banking (Capital) Rules. The Preference Shares would be redeemed for their face value after eight years. Dividends, being cumulative, would be paid annually at 7.25% of the issue price.

The Redeemable Preference Shares were shares. Under section 17A(2)(a), share would be excluded from the definition of RCS. Therefore, the Redeemable Preference Shares could not be RCSs.

Example 3

Bank-HK issued AT1 Perpetual Capital Notes of US\$500m which provided annual distributions payable on 30 September each year at 2% per annum plus an amount equal to one half of the final dividends per ordinary share payable in the same year. The Perpetual Capital Notes qualified as AT1 instruments under Schedule 4B to the Banking (Capital) Rules.

Under section 17A(2)(c)(i), debt instruments that carry a contractual right to any distribution or redemption payment that depends to any extent on the results of the business of the issuer of the instrument or of any part of that business are excluded from the definition of RCS. Since distributions of the Perpetual Capital Notes would depend partly on the results of the business of Bank-HK, they could not be RCSs.

Example 4

Bank-HKBr was the Hong Kong branch of Bank-F which was a non-resident financial institution whose head office was situated in Jurisdiction-F, a member jurisdiction of the Basel Committee. Bank-HKBr issued AT1 Perpetual Capital Notes of US\$500m to Bank-F to fund its operations in Hong Kong.

Bank-HKBr was not required to comply with the Banking (Capital) Rules in Hong Kong though Bank-F might be required to comply with the equivalent laws or regulatory requirements of Jurisdiction-F. The Perpetual Capital Notes do not fall within the definition of RCS as they would not form a component of AT1 capital for the purposes of regulatory capital requirements in Jurisdiction-F.

REGULATORY CAPITAL SECURITIES TREATED AS DEBT SECURITIES

Sums treated as interest payable

20. Section 17B provides that for the purposes of profits tax:
- (a) a RCS is to be treated as a debt security; and
 - (b) any sum payable in respect of a RCS by its issuer, other than a repayment of the paid-up amount of the RCS, is to be treated as interest payable on money borrowed by the issuer of an amount equal to the paid-up amount of the RCS.

That is, instruments falling within the definition of RCS will be treated as debt securities for both deduction and taxation purposes regardless of their accounting treatment. Sums payable in respect of a RCS by the issuer, other than a repayment of the paid-up amount of the RCS, are to be treated as interest payable on money borrowed by the issuer of an amount equal to the paid-up amount of the RCS. Such sums include coupon payments, premium paid and discount given. The tax treatment should not be affected by section 1(d) of Schedule 4C to the Banking (Capital) Rules which requires that the recognition of a T2 instrument in regulatory capital is to be amortized on a straight line basis of 20% per year in the remaining 5 years before maturity.

21. Section 16(2AA) provides that the provisions in section 16(1)(a) and (2)(a), which concern deductibility of interest expenses, equally apply in relation to a sum payable by a financial institution in respect of a RCS.

22. Section 16(2AAB) provides that the provisions in section 16(1)(a) and (2)(ab), which concern deductibility of interest expenses, apply in relation to a

sum payable by a LAC banking entity in respect of a RCS.

Example 5

Bank-HK issued AT1 Perpetual Capital Notes of US\$300m with discretionary semi-annual coupon payments of 6% per annum. The terms and conditions provided a permanent write-down in full on the non-viability of Bank-HK. The Perpetual Capital Notes qualified as AT1 instruments under Schedule 4B to the Banking (Capital) Rules and were accounted for as equity instruments. The subscription proceeds of US\$300m were taken directly to equity, as were the coupon payments and amounts paid on redemption.

Despite the accounting treatment, the Perpetual Capital Notes would be treated as debt securities under section 17B(1)(a) and the coupon payments would be treated as interest under section 17B(1)(b).

Example 6

Holding Company-HK was incorporated in Hong Kong and its only business activities were the issuing of external funding instruments and the holding of funding instruments issued by Bank-HK. Bank-HK was incorporated in Hong Kong and was a financial institution wholly owned by Holding Company-HK. Holding Company-HK was classified as a resolution entity under a preferred resolution strategy for Bank-HK. Holding Company-HK issued 2-year Fixed Rate Senior Notes of US\$20 million which provided coupon at 3.1% per annum payable in equal semi-annual payments in arrears on 4 March and 4 September of each year. The Senior Notes were bail-inable and qualified as external LAC debt instrument under Schedule 1 to the LAC Rules.

Holding Company-HK was a clean HK holding company, as defined by rule 2(1) of the LAC Rules. Holding Company-HK was thus a LAC banking entity as defined under section 2 of the IRO. Since the Senior Notes fall within the definition of RCS, they would be treated as debt securities under section 17B(1)(a) and the coupon payments would be treated as interest under section 17B(1)(b).

Holding Company-HK would be entitled to claim the interest deduction under section 16(2)(ab).

Sums treated as chargeable profits

23. Section 15(1C) provides that, subject to sections 17B to 17G, section 15(1)(f), (g), (i), (ia), (j), (k), (l) and (la) applies to a RCS. Section 15(1D) provides that, subject to sections 17B to 17F, section 15(1)(ib) and (lb) applies to a RCS held by a LAC banking entity. That means, the following holders of RCSs will have certain sums be treated as trading receipts chargeable to profits tax:

Corporation

- (a) sums payable in respect of a RCS (other than a repayment of paid-up amount) received by or accrued to a corporation carrying on a trade, profession or business in Hong Kong that are derived from Hong Kong;
- (b) sums received by or accrued to a corporation carrying on a trade, profession or business in Hong Kong by way of gains or profits arising in or derived from Hong Kong from the sale or other disposal or on the redemption, on maturity or presentment or otherwise, of a RCS;

Person other than corporation

- (c) sums payable in respect of a RCS (other than a repayment of paid-up amount) received by or accrued to a person, other than a corporation, carrying on a trade, profession or business in Hong Kong that are derived from Hong Kong and are in respect of the funds of the trade, profession or business;
- (d) sums received by or accrued to a person, other than a corporation, carrying on a trade, profession or business in Hong Kong by way of gains or profits arising in or derived from Hong Kong from the sale or other disposal or on the redemption, on maturity or presentment or otherwise, of a RCS where such

gains or profits are in respect of the funds of the trade, profession or business;

Financial institution

- (e) sums payable in respect of a RCS (other than a repayment of paid-up amount) received by or accrued to a financial institution that arise through or from its business in Hong Kong, notwithstanding that the moneys in respect of the RCS are made available outside Hong Kong;
- (f) sums received by or accrued to a financial institution by way of gains or profits arising through or from its business in Hong Kong from the sale or other disposal or on the redemption, on maturity or presentment or otherwise, of a RCS, notwithstanding that the moneys laid out for the acquisition of the RCS were made available outside Hong Kong or the sale, disposal or redemption is effected outside Hong Kong;

Corporation carrying on intra-group financing business

- (g) sums payable in respect of a RCS (other than a repayment of paid-up amount) received by or accrued to a corporation, other than a financial institution, that arise through or from its intra-group financing business in Hong Kong, even if the moneys in respect of the RCS are made available outside Hong Kong;
- (h) sums received by or accrued to a corporation, other than a financial institution, by way of gains or profits arising through or from its intra-group financing business in Hong Kong from the sale or other disposal or on the redemption, on maturity or presentment or otherwise, of a RCS, even if the moneys laid out for the acquisition of the RCS were made available outside Hong Kong or the sale, disposal or redemption is effected outside Hong Kong;

LAC banking entity

- (i) sums payable in respect of a RCS (other than a repayment of paid-up amount) received by or accrued to a LAC banking entity that arise through or from its business in Hong Kong, even if the moneys laid out for the acquisition of the RCS are made available outside Hong Kong; and
- (j) sums received by or accrued to a LAC banking entity by way of gains or profits arising through or from its business in Hong Kong from the sale or other disposal or on the redemption, on maturity or presentment or otherwise, of a RCS, even if the moneys laid out for the acquisition of the RCS were made available outside Hong Kong or the sale, disposal or redemption is effected outside Hong Kong.

ISSUERS AND SPECIFIED CONNECTED PERSONS

Specified connected person

24. For the purposes of section 17D, SCP is defined in section 17D(5) to mean a connected person (CP) of the issuer who is not excepted within the meaning of section 17D(6). Section 17D(5) further defines CP to mean:

- (a) an associated corporation (same meaning as in section 16(3)) of the issuer; or
- (b) a person (other than a corporation) who –
 - (i) controls the issuer;
 - (ii) is controlled by the issuer; or
 - (iii) is under the control of the same person as is the issuer.

25. Section 17D(6) provides that a CP of the issuer of a RCS is excepted if the CP:

- (a) is entitled to a sum payable in respect of the RCS in the capacity of –
 - (i) a person acting as a trustee of a trust estate, or holding property belonging to others pursuant to the terms of a contract, where the person is not beneficially entitled to the sum;
 - (ii) a beneficiary of a unit trust to which section 26A(1A)(a)(i) or (ii) applies, where the sum is payable to a trustee of the unit trust in respect of a specified investment scheme referred to in section 26A(1A)(b); or
 - (iii) a member of a retirement scheme that is either a recognized retirement scheme or a substantially similar retirement scheme established outside Hong Kong, where the Commissioner is satisfied that the latter scheme complies with the requirements of a supervisory authority within an acceptable regulatory regime;
- (b) is a market maker who, in the ordinary course of conduct of the market maker's trade, profession or business in respect of market making, holds the RCS for the purpose of providing liquidity for the RCS;
- (c) is a public body; or
- (d) is a body corporate, where the Government owns beneficially more than half of the issued share capital of that body corporate for the time being.

26. For the purposes of section 17F, SCP is defined in section 17F(9A) to mean a CP of the issuer of a RCS, as defined by section 17D(5), unless the CP:

- (a) is chargeable to profits tax in respect of a sum payable in respect of the RCS; or

- (b) falls within the exceptions in paragraph 25 above.

27. The term “market maker” is defined in sections 17D(5) and 17F(9) to mean a person who:

- (a) is licensed or registered for dealing in securities under the Securities and Futures Ordinance (Cap. 571) or is authorized to do so by a regulatory authority in a major financial centre outside Hong Kong recognized by the Commissioner for the purposes of sections 17D and 17F respectively;
- (b) in the ordinary course of conduct of the person’s trade, profession or business in respect of market making, holds oneself out as being willing to buy and sell securities for the person’s own account and on a regular basis; and
- (c) is actively involved in market making in securities issued by a wide range of unrelated institutions.

Under normal circumstances, long-term or substantial holdings of RCSs will not be considered as consistent with market making activities. For this purpose, a holding of over 5% of an issue for a period of over 3 months will not be taken as a holding of the RCSs in the ordinary course of conduct of market making activities, unless the Commissioner is satisfied that there are reasonable explanations for doing so.

Fair value accounting not accepted

28. Section 17C(2) provides that profits of the issuer of a RCS are to be determined as if fair value accounting were not generally acceptable accounting practice in relation to the RCS or part of the RCS. The effect is that any change in fair value of the RCS or any part of the RCS will be disregarded for tax assessment purposes.

29. Where a holder of the RCS is not a SCP of the issuer, the holder will recognize the profits or losses arising from the RCS in accordance with the accounting treatment of the RCS. If the holder designates the RCS as “fair value through profit and loss” and computes chargeable profits on a fair value

basis, any change in fair value of the RCS will be assessed or allowed when the change is taken to the profit and loss account in accordance with sections 18G to 18L of the IRO.

30. Where the RCS is held by or for the benefit of a SCP of the issuer, section 17D(2) provides that chargeable profits of the SCP are to be determined as if fair value accounting were not generally acceptable accounting practice in relation to the RCS or part of the RCS. Same as the issuer, any change in fair value of the RCS or any part of the RCS will be disregarded when computing chargeable profits of the SCP.

Example 7

Bank-HK issued T2 Capital Notes of US\$500m of 6-year term with mandatory semi-annual coupon payments of 5% per annum to Company-HK, an associated corporation of Bank-HK. The terms and conditions provided a permanent write-down in full on the non-viability of Bank-HK. The Capital Notes qualified as T2 instruments under Schedule 4C to the Banking (Capital) Rules.

Company-HK measured the Capital Notes as a single instrument at fair value through profit and loss. They were measured on initial recognition at its fair value of US\$500m and were subsequently measured at fair value, with the movements recognized as either profits or losses.

Company-HK is a SCP of Bank-HK. To determine the chargeable profits of Company-HK, the fair value adjustment of the T2 Capital Notes would be disregarded in accordance with section 17D(2). The Capital Notes would be treated as debts, having a carrying value of US\$500m. The coupon payments would be recognized as interest income.

31. Regarding a loss arising from a RCS, the loss should be computed as if fair value accounting were not generally accepted accounting practice since section 19D(1) provides that the amount of loss incurred by a person chargeable to profits tax for any year of assessment shall be computed in like manner and for such basis period as the assessable profits for that year of assessment would have been computed.

Write-down or subsequent write up

32. Section 17C(3) provides that any sum representing the paid-up amount of a RCS being written down on a temporary or permanent basis or converted to a CET1 capital instrument (i.e. ordinary share) in accordance with any laws or regulatory requirements or the terms or conditions of the RCS is not to be treated as a receipt arising in or derived from Hong Kong by the issuer from a trade, profession or business carried on in Hong Kong. This is to ensure that the conversion or write-down of the RCS will not in itself trigger a tax liability on the issuer.

33. Correspondingly, section 17C(4) prohibits any deduction to the issuer of a RCS for any sum representing the paid-up amount of the RCS being written up after a temporary write-down.

34. To ensure symmetry of tax treatment of the issuer and the issuer's SCPs, section 17D(3) and (4) provides for tax treatments mirroring those set out in section 17C(3) and (4) when ascertaining the chargeable profits of the issuer's SCPs.

Hedging transactions

35. If a hedging instrument is entered into and designated as an offset to changes in the fair value of a RCS and the hedging relationship qualifies for hedge accounting and is accounted for as such, the tax treatment of the hedging instrument should follow that of the RCS. That means the corresponding changes in fair value of the hedging instrument will also be disregarded. Instead, any net payments made or received under the hedging instrument and its related costs will be brought into account in determining the chargeable profits of the issuer.

36. It is to be noted that AT1 instruments are generally classified as "other equity instruments", which are distinct from "common equity instruments", under the current applicable accounting standards because of its perpetual term and discretionary and non-cumulative coupon payments. For hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions can be designated as hedged items. It is therefore unlikely that an issuer can apply hedge accounting to AT1 instruments.

Example 8

Bank-HK issued T2 Capital Notes of US\$500m of 7-year term with mandatory semi-annual coupon payments of 5% per annum. The terms and conditions provided a permanent write-down in full on the non-viability of Bank-HK. The Capital Notes qualified as T2 instruments under Schedule 4C to the Banking (Capital) Rules.

Bank-HK entered into an interest rate swap with another bank to hedge the fair value risk in the fixed coupon payments under the Capital Notes. This interest rate swap was designated as a hedging instrument of the fair value risk for accounting purposes. Under the swap, Bank-HK received fixed rate payments and paid floating rate interest at 6-month LIBOR, with payments being exchanged semi-annually.

The Capital Notes were measured at fair value through profit and loss. They were measured on initial recognition at its fair value of US\$500m and were subsequently measured at fair value, with the movements recognized as either profits or losses. The interest rate swap was measured at fair value through profit or loss.

The fair value adjustment of the T2 Capital Notes would be disregarded under section 17C(2). The Capital Notes would be treated as having a carrying value of US\$500m, with the coupon payments recognized on an accrual basis. The Capital Notes would be treated as debt securities and the coupon payable as interest payable. Given their hedging relationship, the Capital Notes and the interest rate swap should not be considered separately and the tax treatment of the interest rate swap should follow that of the Capital Notes. Similar to the changes in fair value of the Capital Notes, the changes in fair value of the interest rate swap would be disregarded. The semi-annual net cash payments under the interest rate swap would be brought into account as adjustments to the interest expenses.

Example 9

Bank-HK issued T2 Capital Notes of RMB 600m with semi-annual coupon payments of 5% per annum. The terms and conditions provide a permanent write-down in full on the non-viability of Bank-HK. The Capital Notes qualified as T2 instruments under Schedule 4C to the Banking (Capital) Rules.

Bank-HK entered into a cross-currency swap to exchange interest payments and principal at redemption on the same terms as the Capital Notes and designated the cross-currency swap as a cash flow hedge. Under the cross-currency swap, Bank-HK received RMB interest from and paid HK\$ interest to the counterparty, with payments being exchanged semi-annually.

The Capital Notes were measured at amortized cost. The cross-currency swap was designated as a hedging instrument of the cash flow risk for accounting purposes. The cross-currency swap was fair valued at the end of each accounting period with change in fair value recognized in other comprehensive income and taken to the cash flow hedge reserve in equity. A corresponding amount of cross-currency swap was reclassified from equity to profit or loss at the end of each accounting period to offset the amount recognized for retranslation of the RMB to HK\$ closing rates.

Section 17C(2) would not apply to the cross-currency swap as it did not form part of the Capital Notes. However, the Capital Notes and the cross-currency swap should not be considered separately because the cross-currency swap mitigated the impact of the currency risks under the Capital Notes. Therefore, the tax treatment of the cross-currency swap should follow that of the Capital Notes. The changes in fair value of the cross-currency swap would be disregarded. The Capital Notes would be treated as debt securities and the coupon payable as interest payable. The semi-annual net cash payments under the cross-currency swap would be brought into account as adjustments to the interest expenses.

Restrictions on deduction

37. A number of regulators, including those in the United Kingdom and the United States, increasingly require banks to issue a RCS externally at the top holding company level and then down-stream this to operating subsidiaries through an intra-group RCS, with the aim of facilitating more effective and orderly resolution in the event of a crisis. Section 17F imposes some conditions and restrictions on the deduction of sums payable in respect of a RCS issued to, held by or issued or held for the benefit of, a SCP of the issuer. This is to ensure that the deductible amount is actually an expense paid to a non-SCP of the issuer, while accommodating the down-streaming of a RCS from top holding company as required by regulatory authorities.

38. Section 17F(2) sets out the conditions that must be met in order for a deduction of sums payable in respect of a RCS to be allowable to the issuer of the RCS (*specified issuer*), namely:

- (a) the money paid by or on behalf of the SCP for the issue of the RCS has been entirely funded, either directly or indirectly, by the proceeds of an external issue of a RCS or debenture or debt instrument by the SCP or an associated corporation of the specified issuer; and
- (b) the externally issued RCS or debenture or debt instrument is not at any time during the basis period of the specified issuer for the year of assessment concerned, held by or for the benefit of a SCP of the specified issuer.

Example 10

Bank-HK issued AT1 instruments of US\$200m to Partnership-F in Jurisdiction-F. Holding Company-F, established in Jurisdiction-F, was the holding company of Bank-HK and the majority partner in Partnership-F. Partnership-F paid for the AT1 instruments out of its internal funds. Partnership-F was not subject to Hong Kong profits tax.

Partnership-F was a SCP of Bank-HK. The condition under section 17F(2)(a) was not satisfied since the money paid by Partnership-F for

the issue of the AT1 instruments was not funded directly or indirectly by the proceeds of an external issue of a RCS or debenture or debt instrument.

Example 11

Bank-HK issued AT1 instruments of US\$500m to Holding Bank-F, its holding company in Jurisdiction-F. Immediately before the issue, Holding Bank-F had issued to independent investors of AT1 instruments of US\$500m. Holding Bank-F was not subject to Hong Kong profits tax.

Holding Bank-F was a SCP of Bank-HK. The money paid by Holding Bank-F for the issue by Bank-HK of AT1 instruments was funded directly by the proceeds of an external issue of AT1 instruments by Holding Bank-F. The two conditions under section 17F(2) were satisfied.

Example 12

Independent investors paid US\$1,500m for AT1 instruments issued by Parent Bank-F1 in Jurisdiction-F1. Parent Bank-F1 paid US\$1,500m for AT1 instruments issued by Intermediate Holding Company-F2 which was its immediate subsidiary in Jurisdiction-F2. Intermediate Holding Company-F2 then paid Bank-F3 in Jurisdiction-F3 and Bank-HK in Hong Kong US\$750m each for AT1 instruments issued by them respectively. Intermediate Holding Company-F2 acted as a pure conduit passing down the capital to Bank-F3 and Bank-HK. Both Parent Bank-F1 and Intermediate Holding Company-F2 were not subject to Hong Kong profits tax.

Intermediate Holding Company-F2 was a SCP of Bank-HK. The AT1 instruments issued by Bank-HK to Intermediate Holding Company-F2 were funded indirectly by the proceeds of an external issue of AT1 instruments by Parent Bank-F1 which was an associated corporation of Bank-HK. The two conditions under section 17F(2) were satisfied.

39. If only part of the RCSs issued to a SCP of an issuer meet the conditions under section 17F(2), deduction will only be denied to the extent that the RCSs are not funded through an external issue. A RCS or debenture or debt instrument is externally issued if the RCS or debenture or debt instrument is not issued to, or for the benefit of, a SCP of the issuer.

Example 13

Bank-HK issued AT1 instruments of US\$500m to Parent Bank-F which was its holding company in Jurisdiction-F. Immediately before the issue, Parent Bank-F had issued to independent investors of AT1 instruments of US\$400m. Parent Bank-F funded the balance of the subscription money for the AT1 instruments issued by Bank-HK out of its own reserves. Parent Bank-F was not subject to Hong Kong profits tax.

Parent Bank-F was a SCP of Bank-HK. Only US\$400m of the AT1 instruments would be treated to have satisfied the two conditions in section 17F(2).

Example 14

Bank-HK issued AT1 instruments of US\$500m to Parent Bank-F which was its holding company in Jurisdiction-F. Immediately before the issue, Parent Bank-F had issued to independent investors AT1 instruments of US\$400m and to Company-F, its associated corporation, AT1 instruments of US\$100m. Both Parent Bank-F and Company-F were not subject to Hong Kong profits tax.

Both Parent Bank-F and Company-F were SCPs of Bank-HK. Only US\$400m of the AT1 instruments would be treated to have satisfied the two conditions in section 17F(2).

Example 15

On 1 July Year 1, Bank-HK issued AT1 instruments to Parent Bank-F which was its holding company in Jurisdiction-F. Immediately before the issue, Parent Bank-F had issued to independent investors AT1 instruments of US\$500m which were listed in the Stock Exchange

of Jurisdiction-F. On 1 July Year 2, Company-F, an associated corporation of Parent Bank-F, bought back 20% of the AT1 instruments issued by Parent Bank-F from the market. Both Parent Bank-F and Company-F were not subject to Hong Kong profits tax.

Both Parent Bank-F and Company-F were SCPs of Bank-HK. The two conditions under section 17F(2) were satisfied for Year 1.

From Year 2 and onwards, only 80% of the AT1 instruments issued by Bank-HK to Parent Bank-F would satisfy the two conditions under section 17F(2).

40. The restriction set out under section 17F(3) is that the deduction is not to exceed the sum payable by the SCP or the associated corporation, as the case requires, in respect of the externally issued RCS or debenture or debt instrument, other than the repayment of the paid-up amount.

Example 16

Bank-HK issued AT1 instruments of US\$500m with discretionary semi-annual coupon payments of 7% per annum to Parent Bank-F which was its holding company in Jurisdiction-F. Immediately before the issue, Parent Bank-F had issued to independent investors of AT1 instruments of US\$500m with discretionary semi-annual coupon payments of 6% per annum. Parent Bank-F was not subject to Hong Kong profits tax.

Parent Bank-F was a SCP of Bank-HK. The conditions for deduction under section 17F(2) would be satisfied. However, section 17F(3) would restrict the tax deductible semi-annual coupon payments to US\$30m (i.e. US\$500m × 6%) for each year of assessment.

41. Strictly, the cap on interest deduction as provided in section 17F(3) is related neither to transfer pricing nor to the arm's length principle/ international transfer pricing practices. Section 17F(3) restricts the amount of interest deduction but not the payment of an arm's length remuneration for managing the RCSs of a group.

42. Section 17F(3) can also be regarded and applied as an anti-avoidance provision against “back-to-back transactions”. In practice, before invoking the provision in section 17F(3), the Commissioner would consider the totality of facts, including:

- (a) whether the group’s strategy/ policy, which has to be properly documented, on the external and internal issue of RCSs by its members is commercially viable and realistic;
- (b) whether the relevant internal RCS is funded by the proceeds of a particular external RCS (i.e. tracing approach);
- (c) whether, in case subparagraph (b) is not satisfied, the proceeds from the external issue of a portfolio of RCSs by the group entity outside Hong Kong are used to fund all its internal RCSs issued by group members in and outside Hong Kong within an operating or business cycle which can be clearly identified and consistently determined (i.e. fungibility approach);
- (d) whether the relevant transactions, including the internal RCS arrangements within the group, are at arm’s length in all respects, including in relation to any associated fees charged by the SCP;
- (e) whether the SCP is chargeable to tax, with actual tax payment at an effective rate not lower than the Hong Kong rate, in a territory outside Hong Kong on the interest income and any associated fee received;
- (f) whether the interest and any associated fees payable to the SCP satisfy the deduction requirements of section 16(1) and are not precluded from deduction under section 17; and
- (g) whether the arrangement has features of an arrangement for tax avoidance or any tax avoidance motives.

Example 17

Parent Bank-F1 was incorporated in Jurisdiction-F1. It was responsible for the external issue of AT1/T2 instruments for its subsidiaries, Bank-HK and Bank-F2, which were incorporated in Hong Kong and Jurisdiction-F2 respectively.

Parent Bank-F1 issued to independent investors AT1 instrument of US\$300m in Year 1 and US\$900m in Year 2 on similar terms with discretionary semi-annual coupon payments of 6% per annum. In Year 2, Bank-HK and Bank-F2 issued AT1 instruments of US\$500m respectively with discretionary semi-annual coupon payments of 7% per annum to Parent Bank-F1. Both coupon rates of 6% and 7% were fixed at arm's length. While Parent Bank-F was not subject to Hong Kong profits tax, it paid or was charged corporate tax on semi-annual coupon payments from Bank-HK at a tax rate of 18% in Jurisdiction-F1.

Parent Bank-F1 was a SCP of Bank-HK. The conditions for deduction under section 17F(2) would be regarded as satisfied since the total amount of external issuances by Parent Bank-F1 (i.e. US\$300m + US\$900m = US\$1,200m) exceeded the total amount of internal issuances by Bank-HK and Bank-F2 (i.e. US\$500m + US\$500m = US\$1,000m). In view that there was no evidence showing any tax avoidance motive and that Parent Bank-F1 paid tax on the semi-annual coupon payments at the rate of 18%, which was higher than the tax rate for corporate in Hong Kong, section 17F(3) would unlikely be invoked. The semi-annual coupon payments of US\$35m (i.e. US\$500m × 7%) would be allowable to Bank-HK for deduction in the year of assessment.

43. If the externally issued RCS or debenture or debt instrument is held by or for the benefit of an associate, other than a SCP, of an issuer, section 17F(5) ensures that the amount of the deduction that would have been allowed is not to exceed a reasonable commercial return on money borrowed of an amount equal to the paid-up amount for the externally issued RCS or debenture or debt instrument. Under section 17F(6), a reasonable commercial return means a return that, at the time the RCS or debenture or debt instrument was issued,

would be regarded in the prevailing market conditions as a reasonable commercial return between persons dealing with each other at arm's length in the open market.

44. The provisions in section 17F would not impact on direct issuance of RCSs to third party investors. There are no restrictions on the deduction for RCSs issued to persons other than SCPs of the issuer, provided that the sum payable was incurred in the production of chargeable profits. Nevertheless, if a RCS is issued to an associate of an issuer on non-arm's length terms, the deduction may still be subject to adjustments required in section 17E.

ARM'S LENGTH AND SEPARATE ENTERPRISES PRINCIPLES

Non-arm's length RCS transaction between associates

45. Section 17E ensures that the chargeable profits from a RCS transaction between a financial institution or a LAC banking entity (*specified institution or entity*) and its associate will be determined by reference to the amount of profits that would have accrued had the same transaction been carried out at arm's length terms between persons who are not associates (i.e. arm's length principle).

46. "Associate" has the meaning given by section 16(3). Section 17E sets out the conditions where the profits in respect of transactions in connection with RCS between a specified institution or entity and its associates may be subjected to adjustment. There is no restriction on the scope of transactions. It is wide enough to cover a RCS issued by a specified institution or entity to its associate on non-arm's length terms or a non-arm's length transfer between a specified institution or entity and its associate of a RCS issued by another specified institution or entity.

Example 18

Bank-HK and Company-F1 in Jurisdiction-F1 were partners of Joint Venture Partnership-F2 in Jurisdiction-F2 which was engaged in the business of aircraft leasing. Bank-HK issued to Company-F1 AT1 Perpetual Capital Notes of US\$200m with semi-annual coupon payments of 10% per annum though the then market rate of comparable instruments was 7%.

Company-F1 was a partner of Bank-HK and fell within the meaning of “associate” given by section 16(3). Section 17E would apply to the RCS issuance by Bank-HK to Company-F1. The coupon rate would be adjusted to 7% per annum which was the then prevailing arm’s length rate.

47. Section 17E applies to any RCS transaction involving AT1/T2 instruments carried out on or after 3 June 2016 and other RCS transactions carried out on or after 15 February 2019.

Hong Kong branch of a non-resident financial institution

Distinct and separate enterprise

48. Section 17G ensures that the chargeable profits of the Hong Kong branch of a non-resident financial institution with capital raised through the issue of RCSs will be determined in accordance with the separate enterprises principle. It sets out the basis on which the profits attributable to the Hong Kong branch of a non-resident financial institution with issued RCSs are to be determined. The provisions in section 17G(2) follow the principle that profits are attributable to the Hong Kong permanent establishment of a non-resident enterprise of a Contracting Party to a Double Taxation Agreement (DTA) carrying on business in Hong Kong as if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealt wholly independently of the non-resident enterprise. The principle has been incorporated in Article 7 (Business Profits) of DTAs which are enacted as subsidiary legislation to the IRO.

49. While express reference may not have been made to the functions performed, assets used and risks assumed in Article 7 (Business Profits) of the relevant DTA, it remains clear that application of the principle requires taking into account such factors if profits are to be correctly attributed to the Hong Kong branch of the non-resident financial institution. In practice, when a profits tax assessment is raised, profits will be attributed to the Hong Kong branch in accordance with the provisions in Part 4 of the IRO in a way that ensures the compliance with the terms of Article 7 (Business Profits) of the relevant DTA concluded, if any, with the tax jurisdiction in which the non-resident financial institution resides.

50. Since a payment under a RCS, other than a repayment of the paid-up amount of the RCS, is treated as interest payable under section 17B, the payment will be allowed for deduction under profits tax if it is incurred in the production of the chargeable profits of the Hong Kong branch of the non-resident financial institution. Equally, profits tax deduction can be allowed for any payments made for the use of money, which has been provided to the Hong Kong branch from the issue of a RCS by the non-resident financial institution, to fund the profit generating operations of the Hong Kong branch.

51. If the Commissioner has reasons to believe that the Hong Kong branch of a non-resident financial institution is engaged in tax avoidance transactions, he may request information about the source of funds used by the Hong Kong branch to produce its chargeable profits and its risk weighted assets for calculating its notional regulatory capital ratios.

52. The Commissioner will apply the provisions in section 17G if interest expenses representing excessive payments in relation to RCSs are claimed as a deduction in the computation of the chargeable profits of the Hong Kong branch of a non-resident financial institution. For example, the profit generating operations of the Hong Kong branch are funded wholly or substantially by money raised through or from the issue of RCSs so as to obtain tax deduction not available in the jurisdiction of residency of the non-resident financial institution or in any other tax jurisdictions in which the non-resident financial institution has branches or permanent establishments. In such a situation, the profits of the Hong Kong branch may be recomputed on the basis that the Hong Kong branch has a combination of equity and loan capital that it is reasonably expected to have as if it were a distinct and separate enterprise.

Notional capital structure

53. The Hong Kong branch will be expected to have a capital structure not materially different from that of a financial institution which operates as a separate entity (i.e. having the same proportion of equity and loan capital) as required by the provisions in section 17G(2) and (4). While the provisions in section 17G require the Hong Kong branch of a non-resident financial institution to be regarded as a distinct and separate enterprise carrying on the same or similar activities under the same or similar conditions, there may be good commercial reasons why the activities of the Hong Kong branch differ from those generally

carried on by a separate entity of the same size as the Hong Kong branch carrying on business in Hong Kong. Therefore, it may be difficult to find Hong Kong financial institutions that are truly comparable to the Hong Kong branch in terms of both size and level or types of activities. If an appropriate comparable can be found, then it can be used as an indicator of the amount of equity and of loan capital that the Hong Kong branch should have at arm's length.

54. In most cases, the way the non-resident financial institution, of which the Hong Kong branch is a part, funds itself in the market will be the most obvious measure of an arm's length mix of funding for that financial institution. Where this is the case, there is clearly scope for considering the extent to which the funding of the Hong Kong branch should replicate the funding of the whole non-resident financial institution. Unless the activities carried on by the Hong Kong branch are sufficiently different from those carried on by the non-resident financial institution as a whole (i.e. either inherently riskier or less risky), it may be possible to apply the capital ratios of the non-resident financial institution to the Hong Kong branch.

55. Even where the activities of the Hong Kong branch are sufficiently different from those of the rest of the non-resident financial institution to warrant that the Hong Kong branch should have a somewhat different capital structure, the capital structure of the whole non-resident financial institution could still be used as a starting point with appropriate adjustments being made. While this is one possible way of arriving at an arm's length range of capital, for the purposes of calculating the tax adjustment, a Hong Kong branch may see it as the most straightforward method. The Commissioner will be ready to consider this approach in suitable cases, including those where the nature of the businesses of the non-resident financial institution and the Hong Kong branch differ significantly, but where it is possible to adjust for these differences.

Deemed credit rating

56. The Hong Kong branch is assumed under section 17G(4)(a) to have the same credit rating as the non-resident financial institution of which it is a part. This reflects the economic and legal reality that the Hong Kong branch is able to obtain funds at a cost below that of an independent entity of the same size.

Excessive payments under RCS

57. If excessive payments under RCS are allocated to the Hong Kong branch and claimed for profits tax deduction, a downward adjustment may be required. This may result in a corresponding upward adjustment to its equity capital and ordinary debt capital.

Example 19

Bank-HKBr was the Hong Kong branch of Bank-F which was a non-resident financial institution whose head office was situated in Jurisdiction-F. Bank-HKBr was funded by its head office with:

- (a) short term loans of \$6,000m at an interest cost of 3%;*
- (b) an allotment of AT1 capital of \$1,200m at an interest cost of 7%; and*
- (c) an interest free allotment of CET1 capital of \$250m.*

Bank-HKBr's risk-weighted assets (RWA) aggregated \$7,000m. Bank-HKBr's CET1 capital and AT1 capital expressed as a percentage of its RWA were 3.6% and 17.1% respectively. Bank-F's CET1 capital, AT1 capital and T2 capital expressed as a percentage of its RWA were 12%, 2% and 4% respectively.

The known level of AT1 capital in the banking industry in Hong Kong had a range of 1% to 2% of RWA. The interest rates for AT1 capital and T2 capital issued by Bank-F were 7% and 5% respectively.

Since Bank-HKBr's level of AT1 capital, expressed as a percentage of its RWA, was around 17.1% which was significantly out of line with the level of AT1 capital of Bank-F as a whole or that of resident financial institutions carrying on a banking business in Hong Kong, the provisions in section 17G would be applied in ascertaining the profits of Bank-HKBr.

By applying the CET1, AT1 and T2 capital ratios of Bank-F as a whole to the RWA of Bank-HKBr, an analysis under section 17G(2) and (4) would require Bank-HKBr to have CET1 capital of \$840m, AT1 capital of \$140m and T2 capital of \$280m.

\$870m of AT1 capital could be treated as displaced by additionally attributed \$590m CET1 capital and \$280m T2 capital. \$190m (i.e. \$1,200m – \$140m – \$870m) of AT1 capital might be re-designated as short term loans.

Per the provisions in section 17G(6), no deduction should be allowed for any costs and expenses in excess of those that would have been incurred on the assumptions in section 17G(4). In other words, Bank-HKBr should have such equity and loan capital as it could reasonably be expected to have as if it were a distinct and separate enterprise. In the absence of any other tax abusive transactions, the disallowable interest expenses might be computed as follows –

$$\begin{aligned} & \$590m \times (7\% - 0\%) + \$280m \times (7\% - 5\%) + \$190m \times (7\% - 3\%) \\ & = \$54.5m \end{aligned}$$

Example 20

Bank-HKBr was the Hong Kong branch of Bank-F which was a non-resident financial institution whose head office was situated in Jurisdiction-F. Bank-HKBr was funded by its head office with:

- (a) *short term loans of \$5,000m at an interest cost of 3%;*
- (b) *an allotment of T2 capital of \$500m at an interest cost of 5%;*
- (c) *an allotment of AT1 capital of \$600m at an interest cost of 7%;*
and
- (d) *an interest free allotment of CET1 capital of \$150m.*

Bank-HKBr's risk-weighted assets (RWA) aggregated \$6,000m. Bank-F's CET1 capital, AT1 capital and T2 capital expressed as a percentage of its RWAs were 12%, 2% and 4% respectively.

The known level of AT1 capital in the banking industry in Hong Kong had a range of 1% to 2% of RWA. The interest rates for AT1 capital and T2 capital issued by Bank-F were 7% and 5% respectively.

Since Bank-HKBr's level of AT1 capital, expressed as a percentage of its RWA, was around 10.0% which was significantly out of line with

the level of AT1 capital of Bank F as a whole or that of resident financial institutions carrying on a banking business in Hong Kong, the provisions in section 17G would be applied in ascertaining the profits of Bank-HKBr.

By applying the CET1, AT1 and T2 capital ratios of Bank-F as a whole to the RWA of Bank-HKBr, an analysis under section 17G(2) and (4) would require Bank-HKBr to have CET1 capital of \$720m, AT1 capital of \$120m and T2 capital of \$240m.

\$480m of AT1 capital and \$90m of T2 capital could be treated as displaced by additionally attributed \$570m CET1 capital. \$170m (i.e. \$500m – \$240m – \$90m) of T2 capital might be re-designated as short term loans.

Per the provisions in section 17G(6), no deduction should be allowed for any costs and expenses in excess of those that would have been incurred on the assumptions in section 17G(4). In other words, Bank-HKBr should have such equity and loan capital as it could reasonably be expected to have as if it were a distinct and separate enterprise. In the absence of any other tax abusive transactions, the disallowable interest expense might be computed as follows –

Interest payable under AT1 capital:

$$\$480\text{m} \times (7\% - 0\%) = \$33.6\text{m}$$

Interest payable under T2 capital:

$$\$90\text{m} \times (5\% - 0\%) + \$170\text{m} \times (5\% - 3\%) = \$7.9\text{m}$$

RCS transactions with other parts of non-resident financial institution

58. The Hong Kong branch and other parts of the non-resident financial institution are required by section 17G(5) to conduct transactions in connection with RCS on arm's length terms and conditions. In particular, the rate of interest charged in respect of funds made available to the Hong Kong branch must be computed on an arm's length basis subject to the deemed credit rating provision under section 17G(4)(a), including situations where such funds are raised through or from the issue of a RCS by the non-resident financial institution.

Territorial basis of taxation

59. The application of the provisions in section 17G should not change the territorial basis of taxation in section 14. The separate enterprises principle under section 17G will be applied when attributing the profits that would have accrued to the Hong Kong branch of a non-resident financial institution with capital raised through the issue of a RCS as if the branch were a distinct and separate enterprise, taking into account the functions performed, asset used and risks assumed by the non-resident financial institution through the branch. The territorial source principle will then be applied to determine whether and, if so, the extent to which the attributable profits should be chargeable to Hong Kong profits tax.

60. When administering the provisions of the IRO, the Commissioner will not hesitate to apply the provisions in sections 61 and 61A to combat transactions which are artificial or fictitious or which are designed for the sole or dominant purpose of obtaining tax benefits (e.g. excessive interest payments made to other parts or associated corporations).

61. The provisions of section 17G apply from the year of assessment 2017/18 and onwards.

No derogation effect on other similar laws

62. Sections 17E and 17G are additional to and do not derogate from any other laws on the arm's length and separate enterprises principles such as relevant case law and Articles 7 (Business Profits) and 9 (Associated Enterprises) of DTAs implemented by orders made under section 49. After the enactment of the Inland Revenue (Amendment) (No. 6) Ordinance 2018 (the 2018 Amendment Ordinance) on 13 July 2018 which codified the transfer pricing guidelines promulgated by the Organisation for Economic Co-operation and Development into section 50AAF (Rule 1: Arm's length principle for provision between associated persons) and section 50AAK (Rule 2: Separate enterprises principle for attributing income or loss of non-Hong Kong resident person) of the IRO, section 17E or 17G remains applicable.

63. Compared with Rule 1 in section 50AAF, the scope of section 17E is wider though section 17E relates to RCS. Section 17A(1) adopts the definition

in section 16(3) for “associate” while the term “affected person” in section 50AAG is subject to the participation condition in section 50AAG.

64. Compared with Rule 2 in section 50AAK, the scope of section 17G is also wider though section 17G relates to RCS. The term “Hong Kong branch” is defined in section 17G(7)(b) to mean any business carried on in Hong Kong by a non-resident financial institution while the term “permanent establishment in Hong Kong” in Schedule 17G refers to situations specifically defined.

SPECIAL HOLDING COMPANY OF AUTHORIZED INSTITUTION

Minimum regulatory capital requirements extended

65. The Hong Kong Monetary Authority (HKMA) may extend the minimum regulatory capital requirements to cover the holding company of an authorized institution if the holding company is incorporated in Hong Kong and is not itself an authorized institution, through imposing conditions on the holding company as a controller of the authorized institution under section 70(7) of the Banking Ordinance. The sole purpose of such holding company is merely to hold shares in the authorized institution, though it may conduct other business activities for providing support to the business or activities of the authorized institution.

Instruments issued by holding company for compliance with Basel III capital adequacy requirements

66. Where a holding company of an authorized institution is neither an authorized institution nor a LAC banking entity and issues instruments for compliance with the minimum level of the Basel III capital adequacy requirements imposed by the HKMA, the Commissioner may consider treating the instruments issued by the holding company as debt securities, provided that:

- (a) the Commissioner is satisfied that the instruments are not issued for tax avoidance purposes;
- (b) the instruments are issued solely for the purposes of providing regulatory capital to the authorized institution in strict compliance with the minimum capital requirements imposed

on the holding company and the authorized institution by the HKMA; and

- (c) the instruments would have fallen with the meaning of RCS if they had been issued by an authorized institution.

67. Since the holding company is neither a financial institution nor a LAC banking entity under section 2, section 16(2)(a) and (ab) shall not apply to the holding company. Any distributions in respect of the instruments issued by the holding company, to the extent that they are incurred by the holding company in the production of chargeable profits, may be eligible for deduction under section 16(1)(a) if any of the conditions under section 16(2)(b) to (g) is satisfied, subject to the anti-abuse provisions therein. To obtain further tax certainty, the holding company can make an application for an advance ruling in respect of the tax treatment of such instruments and distributions.

MISCELLANEOUS MATTERS

Amendments to Inland Revenue Rules 3 and 5

68. In view of section 17G enacted under the 2016 Amendment Ordinance, consequential amendments are made to rule 3 of the Inland Revenue Rules, replacing the term “bank” with the term “non-resident financial institution”. Rule 3(1A) is added to clarify that rule 3 has effect to the extent to which it is not inconsistent with sections 17B to 17G.

69. Consequential amendments are also made to rule 5, clarifying that its application is to ascertain and determine profits of the Hong Kong branch of a person, other than a financial institution, whose head office is outside Hong Kong.

70. The amendments to rules 3 and 5 made under the 2016 Amendment Ordinance apply from the year of assessment 2017/18 and onwards.

71. Upon the codification of the transfer pricing rules in Part 8AA under the 2018 Amendment Ordinance, rule 3(1A) is amended and rule 5(1A) is added to clarify that each of rules 3 and 5 has effect to the extent to which it is not inconsistent with section 50AAK.

72. The definition of “permanent establishment” under rule 5(1) is amended to have its meaning given by section 50AAC(5) which gives effect to Schedule 17G to determine whether the non-Hong Kong resident has a permanent establishment in Hong Kong.

73. The amendments to rules 3 and 5 made under the 2018 Amendment Ordinance apply from the year of assessment 2019/20 and onwards.

RCSs issued before 3 June 2016

74. For a RCS, which was qualified as an AT1/T2 instrument for the purposes of the Banking (Capital) Rule, issued before the commencement date of the 2016 Amendment Ordinance (i.e. 3 June 2016), section 7(a) and (b) of Schedule 36 provides that section 17B applies:

- (a) to sums received or accrued in respect of the RCS on or after 3 June 2016 (in so far as it relates to a person to whom or for whose benefit a sum is payable in respect of the RCS); and
- (b) to sums payable in respect of the RCS on or after 3 June 2016 (in so far as it relates to the issuer of the RCS).

75. For a RCS issued before 3 June 2016, section 7(c) of Schedule 36 provides for adjustments of profits if the RCS was previously accounted for at fair value by the issuer. These adjustments are required since the change in fair value was brought into account for assessment prior to the transitional year of assessment.

76. If the profits or losses of the issuer of a RCS, for the year or years of assessment preceding the transitional year of assessment, included any changes in fair value, the liability under the RCS is taken to have been released and re-assumed at its fair value on 3 June 2016. The change in fair value between that date and the end of the basis period for the year of assessment preceding the transitional year of assessment is to be brought into account for computing the assessable profits for the transitional year of assessment.

77. As defined in section 1(d) of Schedule 36, in relation to a person, a year of assessment is the transitional year of assessment if the commencement

date of the 2016 Amendment Ordinance (i.e. 3 June 2016) falls within the basis period of the person for the year of assessment.

Specified instruments issued before 15 February 2019

78. “Specified instrument” is defined in section 1(c) of Schedule 47 to mean an instrument falling within paragraph (c), (d) or (e) of the definition of RCS in section 17A(1).

79. For a specified instrument issued before the commencement date of the 2019 Amendment Ordinance (i.e. 15 February 2019), section 6(a) and (b) of Schedule 47 provides that section 17B applies:

- (a) to sums received or accrued in respect of the specified instrument on or after 15 February 2019 (in so far as it relates to a person to whom or for whose benefit a sum is payable in respect of the instrument); and
- (b) to sums payable in respect of the specified instrument on or after 15 February 2019 (in so far as it relates to the issuer of the instrument).

80. For a specified instrument issued before 15 February 2019, section 6(c) of Schedule 47 provides for adjustments of profits if the specified instrument was previously accounted for at fair value by the issuer. These adjustments are required since the change in fair value was brought into account for assessment prior to the transitional year of assessment.

81. If the profits or losses of the issuer of a specified instrument, for the year or years of assessment preceding the transitional year of assessment, included any changes in fair value, the liability under the specified instrument is taken to have been released and re-assumed at its fair value on 15 February 2019. The change in fair value between the end of the basis period for the year of assessment preceding the transitional year of assessment and 15 February 2019 is to be brought into account for computing the assessable profits for the transitional year of assessment.

82. As defined in section 1(d) of Schedule 47, in relation to a person, a year of assessment is the transitional year of assessment if the commencement date of the 2019 Amendment Ordinance (i.e. 15 February 2019) falls within the basis period of the person for the year of assessment.

Application of section 17D in relation to RCSs issued before 15 February 2019

83. For a RCS issued before 15 February 2019, section 5(b) of Schedule 47 provides for adjustments of profits if the RCS was previously accounted for at fair value by a SCP of the issuer holding the RCS. These adjustments are required since the change in fair value was brought into account for assessment prior to the transitional year of assessment.

84. If the profits or losses of a SCP of the issuer of a RCS, for the year or years of assessment preceding the transitional year of assessment specified in the 2019 Amendment Ordinance, included any changes in fair value, the RCS is taken to have been disposed of and re-acquired at its fair value on 15 February 2019. The change in fair value between the end of the basis period for the year of assessment preceding the transitional year of assessment and 15 February 2019 is to be brought into account for computing the assessable profits for the transitional year of assessment.