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Hong Kong Tax Newsflash: The Banking LAC Tax Draft Bill Explained – In Brief

Introduction

This Tax Newsflash explains how the Inland Revenue Department plans to amend the rules around regulatory capital securities, to apply in respect of instruments issued to meet new loss absorbing capacity requirements, which are in addition to existing regulatory capital requirements.

Following the global financial crisis that occurred in 2007, governments and financial regulators around the world have been seeking to ensure that banks are more resilient; and that they can be 'resolved' or 'wound down' in a manner which has minimal negative impact on public finances should they face financial difficulties.

In Hong Kong, rules introduced earlier this year under the Financial Institutions (Resolution) Ordinance (CAP.628) ("FIRO"), provide new powers to the Hong Kong Monetary Authority ("HKMA") to step-in to manage a failing bank. These powers include the ability to force certain shareholders or creditors holding instruments with 'loss absorbing capacity' ("LAC") to bear first losses without triggering a default or liquidation. This is intended to allow financially distressed banks to continue to operate while further measures are taken by the HKMA in order to stabilize them.

In order for this process to be effective, banks are required to have a minimum threshold of loss absorbing capacity (the banking LAC requirement[1]) in addition to the regulatory capital they hold. Meeting this threshold requirement can be achieved through the issuance of various instruments including ordinary shares, preference shares and 'equity-like' debt.

The taxation of ordinary shares and preference shares is not considered contentious. However, the taxation of 'equity-like' debt has been a source of disagreement between taxpayers and the Inland Revenue Department in the past; and resulted in the introduction of provisions specifying the taxation of regulatory capital securities (or "RCS") in 2016. The recent introduction of the FIRO rules essentially gives rise to a need to revisit and broaden the RCS rules to ensure that they cater for classes of instrument and entities not previously covered.

Accordingly, on 19 October 2018 the Hong Kong Government published a draft bill[2] which, following passage through the legislative council, will amend the Inland Revenue Ordinance (CAP.112) to extend the special tax treatment currently provided to RCS, to other instruments which provide 'loss absorbing capacity'. The draft bill went through its first legislative council reading yesterday. A summary of the key changes proposed by the draft bill is outlined below.

Definition of 'regulatory capital security'

The definition of RCS in section 17A(1)[3] will be expanded. Currently the definition covers additional tier 1 and tier 2 capital instruments, or components of those instruments. The new definition includes other instruments, or components of instruments, which do not form part of a bank's additional tier 1 or tier 2 regulatory capital, but which are considered to have 'loss absorbing capacity' for the purposes of the FIRO. In other words, the definition of RCS will be expanded to be in line with LAC instruments per the FIRO rules.

The relationship between the banking LAC requirement and regulatory capital requirements is complex and not all regulatory capital will qualify for the banking LAC requirement and vice versa. Accordingly, the expansion of the definition of RCS should be helpful in assisting banks to meet the additional buffer of loss absorbing capacity required by the FIRO Rules.

Entities to which the RCS rules apply

The RCS rules as currently drafted only apply to financial institutions. This essentially limits the application of the RCS rules to licensed banks and a small subset of companies exempt from banking regulation.

The proposed rules would broaden the entities eligible to treat RCS as debt (with distributions in respect of the RCS treated as interest) to include 'clean' Hong Kong holding companies and Hong Kong group companies. In order to be eligible, those companies must be subject to a banking LAC requirement under the FIRO Rules (i.e. they must be required by the FIRO Rules to maintain LAC). This change, together with amendments to section 16(2) should allow a broader range of banking group entities to obtain deductions for payments deemed as interest in respect of RCS.

This proposed change of law may be welcomed by industry participants, as the current RCS rules are seen as restrictive and have prevented for example, Hong Kong based non-bank holding companies from issuing RCS to be on-lent throughout the banking group. However, some uncertainty will be caused by the term 'clean holding company' which is not defined, but implies a holding company with few or no assets / liabilities beyond the group it holds and its funding.

Amendments to deeming provisions in sections 15(1) and 15(1C)

Section 15(1C) currently provides that various subsections of section 15(1), which deem interest and amounts otherwise not chargeable to tax, shall apply in respect of RCS.

The proposed rules will introduce two new subsections to section 15(1), which are subsections (ib) and (lb). These subsections act in a similar manner to the other deeming subsections of section 15(1) with respect to interest and other sums not otherwise chargeable to tax. Specifically, they apply to interest, gains and profits arising to LAC banking entities in respect of RCS (as redefined).

A new section 15(1D) will be added to perform a similar function to the existing section 15(1C) in order to provide that the new subsections (ib) and (lb) shall apply in respect of RCS.

Amendments to the corporate treasury center rules

Section 14D(9) currently prevents a financial institution from being a qualifying corporate treasury center. The proposed rules will amend section 14D(9) to also prevent a 'LAC banking entity' from being considered a qualifying corporate treasury center.

Notwithstanding the proposed amendment to section 16(2)(a) that will allow a LAC banking entity to deduct interest in respect of RCS, a LAC banking entity generally will not benefit from the same broad ability to deduct interest as a financial institution. While the proposed rules would prevent a LAC banking entity from being a qualifying corporate treasury center. They should not prevent it from carrying on an intra-group financing business, and so while a LAC banking entity would not be able to benefit from a reduced rate of tax as offered by the corporate treasury center regime, it should still be possible to enjoy the broader ability to claim deductions offered under section 16(2)(g).

Transitional provisions

The proposed rules would be applicable to the year of assessment in which they are legislated, with the majority of operative provisions having effect on a prospective basis from the date of legislation.

The draft bill which contains the proposed rules went through its first reading in the legislative council on 31 October 2018. Typically amendments will be made following the second reading where outside participants are often invited to provide their views.

Reference:

[1] A banking LAC requirement is a rule made pursuant to section 19(1) of the FIRO Rules.

[2] The Inland Revenue (Amendment) (No. 6) Bill 2018

[3] All section references in this article apply to the IRO unless otherwise stated

If you have any questions, please contact one of the following professional:

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