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Potential impact of proposed Regulatory Capital Securities tax legislation to Hong Kong financial institutions

Hong Kong's Inland Revenue (Amendment) (No. 4) Bill 2015, gazetted on 4 December 2015, features new legislation on corporate treasury centers, but it also contains new proposed rules that would clarify the tax treatment of qualifying regulatory capital securities (RCS) issued by financial institutions (FIs) under the Banking (Capital) Rules (or equivalent rules of another member jurisdiction of the Basel Committee on Banking Supervision). This article discusses the potential tax implications of these changes on Hong Kong FIs.

RCS are financial instruments[1] that have features of both debt and equity and that may be written-down or converted into ordinary shares to offset losses at certain points of time. They are designed to meet the capital adequacy requirements of Basel III[2] by increasing bank liquidity and decreasing bank leverage.

1. Summary of proposed tax treatment of RCS

RCS are not clearly treated as debt instruments under the current provisions of the Inland Revenue Ordinance (IRO)[3] , which has created some uncertainty about the tax treatment of such instruments. Accordingly, the bill aims to:

- Deem RCS to be debt securities, so that distributions from RCS (other than the repayment of principal) would be treated as interest expense;
- Deem distributions received from RCS and the profits from the disposal or redemption of RCS to be trading receipts;
- Disregard fair value accounting in determining the profits in relation to RCS; and
- Not treat RCS as shares; hence, no stamp duty would apply in Hong Kong on the purchase and sale of RCS.

[1] RCS may qualify as an "additional Tier 1 capital instrument" (AT1, a qualified capital instrument under Schedule 4B to the Banking (Capital) Rules (Cap. 55 sub. leg. L) or under equivalent laws or regulatory requirements of another member jurisdiction of the Basel Committee) or as a "Tier 2 capital instrument" (T2, a qualified instrument under Schedule 4C to the Banking (Capital) Rules (Cap. 155 sub. leg. L) or under equivalent laws or regulatory requirements of another member jurisdiction of the Basel Committee).

[2] Basel III (following Basel I and Basel II) is a global, voluntary regulatory framework on bank capital adequacy, stress testing and market liquidity risk, developed in response to the deficiencies during the financial crisis in 2007 and 2008. The Basel Committee, of which the Hong Kong Monetary Authority is a member, has decided to implement the Basel III requirements in its member jurisdictions in phases from 1 January 2013 until full implementation on 1 January 2019.

[3] A T2 generally has a predetermined maturity and its distribution is not contingent, so it likely would be regarded as a debt instrument under the current version of the IRO. However, uncertainty in the applicable tax treatment exists for an AT1.

Certain measures under the bill have led to concerns that it would change the operation of Hong Kong's current territorial system of taxation to Hong Kong branches of overseas financial institutions with RCS issued and that it would impose an overly strict "tainting" rule (see point 4) to disallow a deduction for certain distributions of RCS. These issues are discussed below.

2. Territorial source

As noted above, there is some concern that the bill would change the application of the territorial-source principle to Hong Kong branches of overseas financial institutions with RCS issued.

Currently, under the territorial-source principle in section 14(1) of the IRO, Hong Kong profits tax may be levied only on profits arising in or derived from Hong Kong; foreign-source income is not taxable.

Provisions of the bill that potentially could affect the application of the territorial-source principle include the following:

- Section 17E provides that if an FI and an associated person act under conditions that are not at arm's length in connection with RCS, the profits of the FI or the associated person may be adjusted.
- Section 17G(2) deems the profits of a Hong Kong branch of a nonresident FI that raises capital through the issuance of RCS to be calculated as if the branch were a "*distinct and separate enterprise that (a) engaged in the same or similar activities under the same or similar conditions; and (b) dealt wholly independently of the non-resident financial institution.*"
- Section 17G(3) provides that, in applying section 17G(2), the "*functions performed, assets used and risks assumed*" by nonresident FI through its Hong Kong branch should be taken into account.
- Section 17G(5) provides that RCS transactions between the Hong Kong branch and nonresident FI will be treated as carried out at arm's length terms.
- Section 17H provides that sections 17E and 17G do not prevent principles similar to the arm's length principle and the separate enterprise principle from applying to persons or circumstances not mentioned in those sections.

3. Distinct and separate enterprise

First of all, there is a question as to whether there is a need to deem the Hong Kong branch of a non-resident FI to be a "distinct and separate enterprise". If this legislation had been proposed thirty years ago after the tax case of Banque Nationale de Paris Hong Kong Branch v CIR[4] ("BNP case") held in 1985, this would have been much easier to understand. Under the BNP case, deduction of (notional) interest expense charged to a Hong Kong branch of BNP by its overseas head office was disallowed on the grounds that the head office and the branch are the same legal entity and it cannot have a legal obligation to pay itself. However, the decision of this case has not been strictly enforced in practice. Interest expense charged by the head office of an overseas FI to its Hong Kong branch would generally be accepted by the Inland Revenue Department ("IRD") as deductible as if the head office and the branch were separate legal entities . Accordingly, it seems S17G(2) was not enacted in response to the BNP case. So what is then the legislative intent of S17G(2)? The following statements provided by the Hong Kong government may provide a clue:

In January 2016, the Hong Kong government issued a statement[5] clarifying that section 17G(5) aims to ensure that "*any RCS transactions between the Hong Kong branch of a non-resident bank and any other parts of the same bank are treated as taking place at arm's length terms."* However, there is some concern that, under a literal interpretation of section 17G, its coverage would extend beyond RCS transactions and would apply to all transactions of the Hong Kong branch, in determining the profits of the branch. In other words, the long-established territorial-source principle under section 14 of the IRO may no longer be applicable in determining the profits of the branch.

The government addressed this concern in its statement, as follows:

> "*The proposed section 17H should not be read, on proper interpretation, as importing the arm's length and separate enterprise principles to any other areas. Section 17H states in the negative that the proposed sections 17E and 17G do not prevent those principles from applying to persons or in circumstances other than those mentioned in those sections."*

The government also pledged to clarify the application of section 17G in a departmental interpretation and practice note (DIPN) once the bill is passed.

[4] 2 HKTC 139

[5] The statement was jointly issued by the Financial Services and the Treasury Bureau, the IRD and the Hong Kong Monetary Authority in January 2016 in the Legislative Council, L.C. Paper No. CB(4)534/15-16(01).

However, the government's explanation does not address the fact that, under section 17H, "sections 17E and 17G do not prevent principles similar to those provided for in those sections from applying" (emphasis added). In other words, section 17H could be interpreted as preventing principles that are not similar to the principles under section 17G, such as the territorial-source principle under section 14(1) of the IRO, from applying to Hong Kong branches of nonresident FIs that raise capital through the issuance of RCS.

In relation to profits allocated to a Hong Kong branch of an overseas FI, the government has stated that:

> *"Currently, the 'separate enterprise principle' is enshrined in Article 7 [6] of the DTAs [i.e. tax agreements] concluded by Hong Kong with a number of tax jurisdictions…. In practice….profits will be attributed to the Hong Kong branch in a way that ensures the compliance with the 'separate enterprise principle.'"*

Accordingly, there is a possibility that the IRD may wish to create a new way of ascertaining the profits of an overseas FI's Hong Kong branch under the broader framework of the OECD's base erosion and profit shifting (BEPS)[7] initiative.

The way an overseas FI allocates its profits to its Hong Kong branch currently varies from FI to FI. Many overseas FIs design their own criteria for allocation, and one widely used criterion is the "effectively connected" test, i.e. the management of the FI allocates a portion of profits to its Hong Kong branch by looking at how effectively connected the Hong Kong branch's operations are to the overall profit-generating operations of the FI. Although this test is, in a way, close to the "functions performed, assets used and risks assumed" test proposed under section 17G(3) of the bill, the two tests are not the same. In addition, it is not entirely clear whether an FI still could argue that part of the profits allocated to Hong Kong under section 17G(3) is "offshore sourced" and nontaxable under the territorial-source principle in section 14(1) of the IRO. If this is not possible, in theory or in practice, it would create two different ways of ascertaining FIs' profits in Hong Kong, depending on whether the FI issues RCS:

- The profits of Hong Kong-incorporated FIs, as well as overseas FIs[8] that do not issue RCS, still would be determined under section 14 of the IRO, according to the territorial principle; and
- The profits of FIs incorporated outside Hong Kong that have issued RCS would be determined in accordance with section 17G of the bill.

This could create a difference in tax treatment between a Hong Kong branch of an overseas company and a Hong Kong resident person, which could be challenged under the nondiscrimination article of an applicable DTA (such as the relevant provision in the Hong Kong-Netherlands DTA)[9]. In such a case, the branch treated less favorably than a resident person could file a claim under the mutual agreement procedure of the relevant DTA.

4. Tainting rule

Section 17F of the bill would disallow the deduction for all distributions (treated as interest expense for tax purposes) paid under RCS if any RCS is issued to, held by or issued or held for the benefit of a specified connected person, unless the proceeds used to subscribe to the RCS have been entirely funded (directly or indirectly) by an external issue of RCS, debentures or debt instruments. A specified connected person is defined under section 17D(5) as a connected person of the issuer, other than a person that generally is:

- Chargeable to tax in respect of a sum payable in respect of RCS;
- A trustee;
- A beneficiary of a unit trust;
- A member of a retirement scheme;
- A "market maker";
- A public body; or

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6 Article 7 of a DTA that follows the OECD model treaty covers business profits. Under this article, profits are attributed to a permanent establishment (i.e. the branch) as if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with other entities.

7 In a G20 meeting in November 2012, the leaders called for coordinated actions to strengthen international tax standards and to support the OECD's initiative to identify possible gaps in tax laws. As a consequence, the OECD published a report known as "Addressing Base Erosion and Profit Shifting" in February 2013, focusing on the existence and magnitude of BEPS. Subsequent work on various BEPS actions has continued since that time.

8 If the jurisdiction in which the overseas FI is a tax resident has a DTA with Hong Kong, the profits of the Hong Kong branch of the overseas FI would be determined according to the business profits article of the relevant DTA. See also footnote 12.

9 Article 24(3) of the Hong Kong-Netherlands agreement provides that "the taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents."

- A body corporate that is more than 50% beneficially owned by the government.

In other words, if any part of the RCS is subscribed to by a connected person whose income from the RCS is not subject to Hong Kong profits tax, the entire amount of distributions made under the RCS would be "tainted" and disallowed as a deduction. In the commercial world, although the intent for issuing the RCS may be wholly for public subscription, it is not uncommon for part of the RCS to be subscribed to by related parties when public subscription is insufficient. Since RCS are issued by overseas FIs, the related parties to subscribe for the RCS usually would be overseas entities whose income is not chargeable to Hong Kong profits tax, i.e. specified connected persons by definition. The deduction for the entire amount of interest payable under the RCS would be disallowed in such circumstances.

5. Comments

The measures under the bill that could affect the allocation of profits to an FI's Hong Kong branch would have a significant impact on overseas FIs with branches in Hong Kong. It would become a very important decision for overseas FIs whether to raise capital through the issue of RCS (even if the RCS are not allocated to their Hong Kong branches)[10] because this potentially could impact the amount of taxable profits in the Hong Kong branches in ways beyond the tax effect of whether the RCS are treated as debt for Hong Kong profits tax purposes.

For example, under the current rules, assume that an FI's Hong Kong branch has HKD 100 million in profits, and 30% of the profits is claimed as offshore-source and nontaxable (assume that 30% profits are also not taxable in the head office jurisdiction). Under the new criteria of sections 17G(3) to 17G(5) of the bill, the profits of the Hong Kong branch could be treated as HKD 80 million, with no offshore claim allowed (assuming the profits allocated correspond to the level of activities carried out in Hong Kong, which would leave very limited room for an offshore profits claim). The HKD 20 million of profits (100m – 80m), the difference in profits between the existing territorial source principle and the proposed bill, could now likely be taxable for the head office jurisdiction. This, however, would be somewhat in line with the avoidance of double nontaxation principle under BEPS action 6[11] as well as the transfer pricing methodologies under BEPS actions 9 and 10[12].

If the government's intention is to restrict the application of section 17G to RCS transactions, more clarity should be provided under the law itself, rather than through a DIPN.

In respect of the tainting rule, the IRD hopefully will relax this rule by, for example, disallowing the deduction for only the portion of the distribution relating to the shares subscribed to by specified connected persons, as opposed to disallowing the deduction for the full amount of the distributions.

The bill has not yet been passed. It is hoped that changes will be made to the draft during the legislative process to resolve the issues identified in this article.

[10] Section 17G(1) provides that as long as a nonresident FI raises capital through the issuance of RCS, other provisions of section 17G would apply to its branch in determining its Hong Kong profits, regardless of whether any of the RCS are allocated to the Hong Kong branch.

[11] The final report on BEPS action 6, "*Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*," recommends a three-pronged approach, which Hong Kong may adopt for its DTAs. One recommendation is to include in the title and preamble of a DTA a clear statement that the two parties to the DTA intend to avoid creating opportunities for nontaxation or reduced taxation through tax evasion or avoidance.

[12] See the BEPS final reports on action 9, "*Assure that transfer pricing outcomes are in line with value creation: risks and capital*"; and action 10, "*Assure that transfer pricing outcomes are in line with value creation: other high-risk transactions*."

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