

## Tax

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# Tax Analysis

## How Banks Navigate the Hybrid Maze: Regulatory Capital Securities and Profits Tax

In the wake of the 2008 global financial crisis, the regulatory landscape for financial institutions shifted permanently. The introduction of Basel III<sup>1</sup> forced banks to rethink their capital structures, leading to the rise of Regulatory Capital Securities. However, for a long time, these instruments lived in a "tax limbo" in Hong Kong. This is because these instruments inhabit a "grey zone" between debt and equity, creating significant friction with traditional tax principles.

### Understanding Regulatory Capital Securities (RCS) in Hong Kong

RCS<sup>2</sup> are hybrid financial instruments issued by banks to meet the stringent capital adequacy requirements set by the Hong Kong Monetary Authority (HKMA) under the Banking (Capital) Rules. Their primary purpose is loss absorption; they ensure that if a bank hits a "point of non-viability<sup>3</sup>," the security can be written down or converted into equity to save the institution without a taxpayer bailout. From a regulatory perspective, they are capital; from an accounting perspective, they often resemble equity; but for tax purposes, their classification remained a point of contention until legislative intervention.

In the Hong Kong market, two types of RCSs are prevalent:

- **Additional Tier 1 (AT1) Capital:** These are often perpetual (no fixed maturity) and have "coupon" payments that the bank can cancel at its discretion. Because of these features, they are frequently classified as equity for accounting purposes.

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<sup>1</sup> 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 HKMA is a member, has decided to implement the Basel III requirements in its member jurisdictions in phases from 2023 until full implementation in 2028.

<sup>2</sup> Under the Inland Revenue Ordinance (IRO), specifically Section 17A(1) of the IRO, an RCS is defined by reference to the Banking (Capital) Rules. It refers to a security issued by a "LAC banking entity" (a locally authorized institution) that qualifies as regulatory capital.

<sup>3</sup> A regulatory trigger point determined by the HKMA at which a financial institution is deemed no longer able to survive on its own. Upon reaching this threshold, the terms of the RCS mandate a mandatory write-down or conversion into ordinary shares to absorb losses and recapitalize the bank, thereby preventing a public bailout.

- **Tier 2 (T2) Capital:** These usually have a fixed term (dated) and are subordinated to depositors but senior to AT1. These typically look more like traditional debt.

### The 2016 Legislative Shift: A Debt-for-Tax Approach

Historically, the Inland Revenue Department (IRD) followed the legal form. Because AT1s are often accounted for as equity, banks could not "accrue" interest in their financial statements. Instead, payments were treated as distributions of profit. Under traditional Hong Kong law, if it is not an interest expense on a "loan" it is not deductible. This created a massive tax disadvantage for Hong Kong banks compared to their global peers.

To fix this, the Inland Revenue (Amendment) (No. 2) Ordinance 2016 was enacted in June 2016. It introduced sections 17A – 17G to the Inland Revenue Ordinance (IRO), essentially "deeming" RCSs to be debt for tax purposes, regardless of their accounting classification. This allows banks to claim a deduction for coupon payments as if they were interest on borrowed money, provided they are issued by an "Authorized Institution".

There is a specific technical hurdle for AT1 instruments. Because AT1s are perpetual and the bank has no legal obligation to pay the interest until it actually declares a payment, the bank cannot "accrue" a provision for the expense in its accounts. Before the relevant sections were codified into the IRO, the statutory framework lacked specific guidance regarding these particular deductions.

### Guarding Against Abuse: The Section 17F Tracing Rule

While Section 17B of the IRO opened the door for deductions, it also installed "guards" to avoid any misapplication (i.e. Section 17F(3) The Tracing Rule).

The tracing rule applies when a bank's associated corporation issues the RCS externally and then "on-lends" the money to the Hong Kong bank. To get the deduction, the bank must be able to "trace" the funds.

The law stipulates that the deduction in Hong Kong is restricted to the amount of interest actually paid by the associate to the external investors. If the offshore entity is charging the Hong Kong branch a higher interest rate than what it pays out to the market, the "excess" is strictly non-deductible.

## Deductibility of AT1 in Chinese Mainland

### Overview

Capital-supplementing bonds issued by Chinese mainland banks are an important tool for banks to replenish capital. Under the Measures for Capital Management of Commercial Banks and related regulatory requirements, these bonds fall primarily into two categories: Perpetual Bonds - AT1 equivalent (bonds with no fixed maturity date) and T2 Capital Bonds.

### Bank Perpetual Bonds (AT1 Equivalent): A Dual-Track Elective Regime

Chinese mainland has a specific income tax policy for perpetual bonds, Circular [2019] No. 64 issued by Ministry of Finance and State Taxation Administration concerning tax, which established a "dual-track elective" approach, allowing issuers to select their preferred tax treatment on a bond-by-bond basis. Once elected, the choice is irrevocable and must be noted in the issuance documents for investors.

#### Option 1: Equity Treatment (The Prevailing Approach for Bank Perpetual Bonds)

Under equity treatment, the tax treatment of perpetual bond coupon payments resembles an equity distribution. The issuer (the bank) may not deduct interest payments for income tax purposes (treated as

post-tax expenditure, akin to a dividend distribution), and the investor's coupon income is characterized as dividend income.

In practice, this is the prevailing treatment for bank-issued perpetual bonds (AT1 capital instruments), as banks typically prioritize satisfying regulatory capital recognition requirements.

#### Option 2: Debt Treatment (Conditional; Rarely Adopted by Banks)

Circular 64 provides that where a perpetual bond meets at least five of the following nine conditions, the issuer may elect debt treatment: (i) the investee has an obligation to repay principal; (ii) there is a clearly agreed interest rate and payment frequency; (iii) there is a defined investment term; (iv) the investor does not hold ownership over the investee's net assets; (v) the investor does not participate in the investee's day-to-day operations; (vi) the investee has a right of redemption; (vii) the investee records the investment as a liability; (viii) the investment does not bear the same operating risks as the investee's shareholders; and (ix) the investment ranks ahead of the investee's ordinary shareholders in a liquidation.

Under this option, the issuer's (the bank) interest payments may be deducted for corporate income purposes, while the investor's coupon income should be included in full in taxable income. Since bank AT1 instruments are typically classified as equity instruments in the issuer's accounts (a prerequisite for meeting regulatory capital recognition requirements), they frequently fail to meet the above qualifying conditions, making this option difficult to apply in practice.

#### **Navigating Tax Asymmetry – The South East Asia Trap**

Beyond the Greater Bay Area, regional banks can face significant **tax asymmetry** in Asia Pacific. Unlike Hong Kong, these jurisdictions often strictly adhere to the legal accounting classification of the instrument.

- **Malaysia:** While the Inland Revenue Board (IRB) has issued guidelines, the deductibility of AT1 coupons often hinges on the specific debt vs equity classification. If the IRB views the distribution as a dividend (due to its discretionary nature), the bank loses the deduction, leading to a higher tax cost compared to a Hong Kong-issued equivalent.
- **Indonesia:** Indonesia generally applies a specific Debt-to-Equity ratio. While banks are often excluded from this ratio, they are not immune to "recharacterization." If an AT1 is held by a connected parent, the Indonesian tax authorities may reclassify the "interest" as a "dividend" if the instrument lacks enough debt-like features.

This creates a "Double Taxation" scenario. The payer (the bank) cannot deduct the expense, but the recipient (the investor or group entity) may still be taxed on the income. For a Hong Kong-based investor, this asymmetry requires careful "Hybrid Mismatch" modeling to ensure the group isn't paying tax on the same dollar of profit in two different places.

#### **What Taxpayers Should Be Aware Of?**

Taxpayers should pay close attention to three key risk areas:

- **Booking and accrual treatment** – Perpetual AT1 classified as equity under Hong Kong Financial Reporting Standards may likely result in interest deductions disallowed, regardless of cash payments.
- **Tracing of borrowed funds** – Under section 17F of the IRO, failing to appropriately document the fund-flow link between external borrowings and RCS investments can result in disallowance of related interest expense.
- **Cross-border asymmetry** – Divergent classification rules particularly in South East Asia can create permanent tax costs for regional holdings.

Given the IRD's active scrutiny and the complexity of these rules, taxpayers are strongly encouraged to seek professional advice tailored to their specific capital structures before filing their next profits tax return.

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