Deloitte. 德勤

Tax
Issue P423/2026 – 14 September 2026

Tax Analysis

How Banks Navigate the Hybrid Maze: Tier 2 Regulatory Capital Securities

In our last edition[1], we explored the overall Hong Kong Regulatory Capital Securities (RCS) regime. We also discussed how the taxman treats Additional Tier 1 (AT1) capital instruments. In this issue, we shift our focus to **Tier 2 (T2) RCS**.

While both AT1 and T2 RCS fall under the specialized tax framework, T2 instruments have very distinct rules for their setups and accounting. Below we break down the key differences, tax rules and anti-avoidance traps you need to know.

Key Differences: AT1 vs T2 Capital Securities

Metric	AT1 Capital Securities	T2 Capital Securities
Tenor	Perpetual (no fixed end date)	Dated maturity (fixed end date)
Coupon Payment	Fully discretionary and non-cumulative	Mandatory scheduled payments
Accounting Classification	Classified as **Equity**	Classified as **Financial Liability**

Hong Kong

Key Tax Rules for T2 Capital Securities in Hong Kong

Under Section 17B of the Inland Revenue Ordinance (IRO), T2 securities are **legally treated as debt securities for tax purposes**, regardless of their accounting classification.

- **Deemed Debt Treatment**: Distributions from T2 instruments are counted as **interest payments**. Issuers may claim them as deductible expenses for **Profits Tax purposes**.

Authors:

Hong Kong

Derek Lam
Tax Partner
Tel: +852 2238 7388
Email: dereklam@deloitte.com.hk

Simon Chung
Tax Director
Tel: +852 2258 6136
Email: simochung@deloitte.com.hk

China

Natalie Yu
Tax Partner
Tel: +86 10 8520 7567
Email: natyu@deloittecn.com.cn

For more information, please contact:

Financial Service Industry
Hong Kong Leader

Roy Phan
Tax Partner
Tel: +852 2238 7689
Email: rphan@deloitte.com.hk

[1] Please refer to our previous Tax Analysis Issue P416/2026.

- **The "No-Share" Exclusion**: To qualify for this tax deductibility, the T2 instrument **cannot be issued in the form of a share**, nor can its terms allow conversion into Common Equity Tier 1 (CET1) capital after a certain period of time.

- **Issuer Eligibility**: Only **Authorized Institutions (AIs)** regulated by the **Hong Kong Monetary Authority** for issuing Basel-compliant instruments may claim this deduction. In specific scenarios, it also applies to a holding company of an AI if the proceeds are passed down solely to satisfy the bank's regulatory capital baseline.

- **Tax for Investors**: Hong Kong corporate investors receiving a distribution from a T2 security would be deemed receiving trading receipts **chargeable to Profits Tax** (provided the income has a Hong Kong source).

- **No Fair Value Accounting**: Under **Section 17C of the IRO**, Profits Tax of the issuer is calculated as if fair value accounting does not apply, any unrealised fair value adjustments must be stripped out.

- **Stamp Duty Exempted:** T2 RCS enjoys complete exemption from Stamp Duty on both primary issuance and secondary market transfers.

General Tax Treatment Comparison Among AT1 and T2 Securities

Metric	AT1 Securities	T2 Securities
Tax Status	Treated as debt	Treated as debt
Distribution Deductibility	**Deductible** as interest	**Deductible** as interest
Stamp Duty	**Exempt** on issuance and transfers	**Exempt** on issuance and transfers
Disallowed Sub-types	Capital shares / CET1 convertible	Capital shares / CET1 convertible

Detailed guidance on the practical calculations and compliance requirements is covered in the Inland Revenue Department's Departmental Interpretation and Practice Notes No. 53.

The Section 17F "Tracing Rule"

The "guarding" tracing rule under Section 17F of the IRO also applies to T2 RCS. To recap, such rule is an anti-avoidance rule to prevent banks from reducing their Profits Tax liability through interest payment on RCS made to affiliated parent or sister companies outside of Hong Kong.

- **The Trigger**: It applies when a bank issues T2 securities to close affiliates outside of Hong Kong.

- **The Rule**: To get a full tax deduction, the bank must show a clear audit trail of the funding, where the money must come from independent third-party market investors, go to the affiliate, and then go to the Hong Kong bank.

- **The Interest**: The internal interest payable by the Hong Kong bank must match or be lower than the ultimate external interest paid to the market.

- **The Impact**: If the bank fails this test, the tax deduction is limited to what the affiliate paid to external investors.

In summary, T2 RCS offers a highly tax-efficient way for banks to raise capital, thanks to the tax deductions and stamp duty exemptions. However, navigating these waters requires strict attention to detail. Banks must ensure alignment between their actual funding paths and the "Tracing Rule" under Section 17F of the IRO where the case may be. Failing to keep a clear audit trail can lead to unexpected tax costs.

China

Deductibility of T2 in Mainland China

Regulatory Overview

T2 capital bonds are dated (fixed-term) subordinated debt instruments issued by Mainland China commercial banks to supplement their regulatory capital. Under the Measures for Capital Management of Commercial Banks and related regulatory requirements, T2 capital bonds rank behind deposits and general unsecured creditors, but ahead of AT1 instruments and equity, and are recognised as T2 regulatory capital in the issuing bank's balance sheet.

Corporate Income Tax (CIT)

T2 capital securities are generally treated as debt instruments for tax purposes. This gives rise to a broadly symmetric tax outcome: the issuing bank may deduct the interest (coupon) payments, while the investor is required to include the corresponding interest income in its taxable income for CIT purposes.

For the issuer, interest expenses paid on bonds issued with regulatory approval may be deducted before tax. The subordinated nature of T2 instruments does not affect deductibility, and reasonable issuance costs may likewise be deducted before tax.

For investors, interest income derived by an enterprise constitutes taxable income. A resident Mainland corporate investor should include the T2 coupons in its taxable income. Interest paid to a non-resident enterprise investor is generally subject to a 10% withholding income tax, to be withheld and remitted by the payer of the interest; the rate may be reduced where an applicable tax treaty provides for a lower rate.

Value-Added Tax (VAT)

For VAT purposes, financial bond interest is likewise characterised as interest income. Under the VAT rules applicable to financial bond interest: interest income derived by financial institutions from financial bonds issued before 8 August 2025 remains exempt from VAT; interest income from financial bonds newly issued on or after 8 August 2025 is subject to VAT (financial institutions generally apply 6% under the general method, while qualifying funds / asset management products apply 3% under the simplified method). Other corporate investors are also subject to VAT on the financial bond interest they receive (generally 6% under the general method).

What Taxpayers Should Be Aware Of?

From a corporate tax perspective, the distributions (interest payments) made on T2 capital securities are generally tax-deductible in major Asian financial hubs, provided they satisfy specific local tax and regulatory conditions.

T2 capital instruments are structured as subordinated debt (unlike AT 1 instruments, which lean closer to equity due to perpetual terms and discretionary coupon cancellations). However, there are still different tax deductions rules from tax authorities in Asia governing whether a deduction can be granted.

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

Tax Analysis is published for the clients and professionals of the Hong Kong and Chinese Mainland offices of Deloitte China. The contents are of a general nature only. Readers are advised to consult their tax advisors before acting on any information contained in this newsletter. For more information or advice on the above subject or analysis of other tax issues, please contact:

Deloitte China Tax and Business Advisory
Victor Li
National Leader
Tel: +86 755 3353 8113
Fax: +86 755 8246 3222
Email: vicli@deloittecn.com.cn

Northern and Western China
Xiaoli Huang
Partner
Tel: +86 10 8520 7707
Fax: +86 10 6508 8781
Email: xiaolihuang@deloittecn.com.cn

Eastern China
Maria Liang
Partner
Tel: +86 21 6141 1059
Fax: +86 21 6335 0003
Email: mliang@deloittecn.com.cn

Southern China
Jennifer Zhang
Partner
Tel: +852 2258 6228
Fax: +852 2815 8005
Email: jennifzhang@deloitte.com.hk

About the Deloitte China National Tax Technical Centre

The Deloitte China National Tax Technical Centre ("NTC") was established in 2006 to continuously improve the quality of Deloitte China's tax services and help Deloitte China's tax team better serve the clients. The Deloitte China NTC issues "Tax Analysis" which are commentaries on newly issued tax laws, regulations, and circulars from technical perspective. The Deloitte China NTC also conducts research and analysis and provides professional opinions on ambiguous and complex issues. For more information, please contact:

Northern and Western China
Tony Zhang
Partner
Tel: +86 28 6789 8008
Fax: +86 28 6317 3500
Email: tonzhang@deloittecn.com.cn

Eastern China
Kevin Zhu
Partner
Tel: +86 21 6141 1262
Fax: +86 21 6335 0003
Email: kzhu@deloittecn.com.cn

Southern China (Mainland)
Tony Yao
Partner
Tel: +86 20 2831 1369
Fax: +86 20 3888 0115
Email: heyao@deloittecn.com.cn

Southern China (Hong Kong)
Doris Chik
Partner
Tel: +852 2852 6608
Fax: +852 2543 4647
Email: dchik@deloitte.com.hk

If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify national marketing team of Deloitte China by email at cimchina@deloitte.com.hk.