

# HONG KONG TAX ALERT

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## Regulatory Capital Securities – IRD Practice Note issued

### Summary

- DIPN 53 provides guidance on the application of the new Regulatory Capital Securities (RCS) rules to banks
- The RCS rules were intended to clarify the tax treatment of certain types of funding instruments issued by banks in compliance with the Basel III capital adequacy requirements
- Banks need to take care with funding arrangements to ensure they comply with these complex rules

On 22 February 2017, the Hong Kong Inland Revenue Department issued Departmental Interpretation and Practice Note 53 (DIPN 53) outlining its view on the application of the Regulatory Capital Securities (RCS) rules enacted in June 2016.

### Background

The RCS rules were intended to clarify the tax treatment of certain types of funding instruments issued by banks in compliance with the Basel III capital adequacy requirements.

The RCS rules codify the treatment of Additional Tier 1 and Tier 2 capital instruments which possess certain debt and equity like features. Notably, these instruments convert into common shares to absorb losses in cases where the relevant bank gets into financial difficulty.

The RSC rules allow for payments under qualifying RCS which are not repayments of principal to be treated as interest for Profits Tax purposes.

Traditionally, under Hong Kong tax law, the nature and treatment of an instrument was determined based on its legal form. If an Additional Tier 1 or Tier 2 instrument was legally classified as debt and used to produce taxable income, a tax deduction for the interest should be allowed. The fact it may be classified as equity for accounting or regulatory purposes should be irrelevant. On this basis, one could argue these complex rules are unnecessary. Nevertheless, it is helpful that the IRD has issued some guidance on how it will approach this issue.

The DIPN can be found on the IRD's website at:  
[http://www.ird.gov.hk/eng/pdf/e\\_dipn53.pdf](http://www.ird.gov.hk/eng/pdf/e_dipn53.pdf)

## Key issues covered in the DIPN

DIPN 53 covers the key definitions of RCS and excluded securities. It provides a number of examples of the calculation of interest paid in respect to RCS.

The main item of interest in DIPN 53 is the application of detailed anti-avoidance measures. There are extensive comments on the application of the rules related to Specified Connected Persons (SCP) and the restrictions imposed on deductions for payments made to related parties. This includes examples of funding raised via RCS issued to an offshore holding company.

There were a number of issues where it was hoped guidance would be provided by the IRD. These included:

- Clarity on exactly how closely aligned in terms of timing and amount the issue of RCS by the holding company had to be to the issue of a matching RCS by the Hong Kong bank.

Unfortunately, the examples in DIPN 53 are relatively simplistic and imply that only funds raised by RCS immediately before the matching RCS is issued in Hong Kong would qualify. Funding a global banking operation is unlikely to be this straight forward.

- Whether the new Section 17G would have more general application so as to require the allocation of core capital and Additional Tier 1 or Tier 2 capital instruments to Hong Kong branches of foreign incorporated banks.

One of the controversial features of the RCS rules is the explicit transfer pricing rules included in Sections 17E and, more particularly, Section 17G applying to Hong Kong branches of foreign banks. Section 17G has the potential to change the approach adopted by most foreign banks. Of particular interest is whether the IRD will use this rule to impute an allocation of core capital to the Hong Kong branch. DIPN 53 does not explicitly remove this risk but implies that Section 17G will only apply if the bank concerned has engaged in tax avoidance which involves the issue of RCS and the claiming of excessive interest on those RCS. That said, the examples cited by the IRD imply that a Hong Kong branch would have an allocation of free capital and suggests the starting point for determining the capital structure of the branch should be consistent with the bank's overall capital structure.

The IRD also makes the general point that, in any event, it will not hesitate to use the general anti-avoidance provisions where a bank is claiming excessive interest deductions.

DIPN 53 also goes on to comment on the position of Hong Kong incorporated non authorised holding companies which may be required by the HKMA to be established for regulatory purpose. Unfortunately, no clarity is provided. Rather, the IRD states that it may consider RCS issued by such a company as debt, but notes that the ordinary interest deduction rules would apply. This is difficult to reconcile with the IRD's statement that, absent these special rules applying to banks, no deduction is available for payments in respect of RCS instruments.

## KPMG comments

As always, with complex legislation such as that for RCS, the "devil is in the detail". The actual application will always be more complicated than any simplified example can hope to demonstrate. This is particularly true when tracing the sources of funding and use of funds by organizations as complex as global banking groups.

While the banking community can take some comfort from DIPN 53, it is clear that the capital structure and funding arrangements employed by banks will require careful examination. Any change should also flow through to pricing of lending and other products. This is especially true in light of the impending enactment of a comprehensive transfer pricing regime in Hong Kong.

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