

Bills Committee on Inland Revenue (Amendment) (No. 6) Bill 2018**Response to questions raised by Legal Service Division of the Legislative Council Secretariat in the letter dated 22 November 2018**

This paper sets out the Government's response to the questions raised by Legal Service Division of the Legislative Council ("LegCo") Secretariat in the letter dated 22 November 2018.

	Clarification sought from LegCo Secretariat	Response
1.	<p><u>Clause 3 – section 2 amended (interpretation)</u></p> <p>Clause 3 seeks to add the definition of LAC banking entity, which means an HK affiliated operational entity or clean HK holding company, both as defined under the Financial Institutions (Resolution) Loss-absorbing Capacity Requirements – Banking Sector) Rules ("Rules") to section 2 of the Inland Revenue Ordinance (Cap. 112) ("IRO").</p> <p>Please clarify whether the meaning of a "holding company" under section 13 of the Companies Ordinance (Cap. 622) also applies in construing "clean HK holding company" in Cap. 112 under the proposed amendment.</p>	<p>Yes, it does. The definition of "clean HK holding company" in the Rules incorporates the definition of "HK holding company" in the Rules, which in turn incorporates the term "holding company".</p> <p>The term "holding company" is defined in section 2(1) of the Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO"), which provides that the term, "in relation to a body corporate, has the meaning given by section 13 of the Companies Ordinance (Cap. 622)".</p> <p>Section 31(1) of the Interpretation and General Clauses Ordinance (Cap. 1) provides that "[w]here any Ordinance confers power to make any subsidiary legislation, expressions used in subsidiary legislation shall have the same meaning as in the Ordinance conferring the power...". By reason of this section, since the term "holding company" has been defined by reference to section 13 of the Companies Ordinance in section 2(1) of the FIRO, the same definition</p>

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		would apply to the Rules and thus would also apply to the definition of “clean HK holding company” under the proposed amendment to the IRO.
2.	<p><u>Clause 8 – section 17A amended (financial institution: interpretation)</u></p> <p>It is proposed in the Bill that the reference to a person’s asset and liability in the definitions of “fair value” and “fair value accounting” under section 17A of Cap. 112 are to be repealed. Please explain the reason(s) for removing such reference in the proposed definitions for “fair value” and “fair value accounting”.</p>	<p>The purpose of amending the definitions of “fair value” and “fair value accounting” is to align the definition of the terms with that in the Hong Kong Financial Reporting Standard 13 (Fair Value Measurement) (“HKFRS 13”) or the International Financial Reporting Standard 13 (Fair Value Measurement). Whilst the entire HKFRS 13 must be looked at to fully understand the term “fair value” and its application, the term is defined at the outset in paragraph 9 of HKFRS 13 as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” Since this definition already makes reference to asset and liability, and paragraph 11 of HKFRS 13 further provides that a “fair value measurement is for a particular asset or liability”, we consider it not necessary to repeat the same in section 17A of the IRO.</p>
3.	<p>Please explain why the proposed new definitions of “fair value” and “fair value accounting” will only apply to the regulatory capital security (“RCS”) but not to other capital securities or instruments held by financial institutions.</p>	<p>HKFRS 13 is applicable to all financial instruments. Therefore, the definition of “fair value” in HKFRS 13 applies to all securities or instruments held by financial institutions for the purpose of preparing their financial statements. However, for the purposes of sections 17A, 17B, 17C, 17D,</p>

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		17E, 17F and 17G, only its application to RCS is relevant.
4.	<p><u>Clause 9 – section 17D amended (financial institution: general provisions on regulatory capital security held by, or for benefit of, issuer’s specified connected person)</u></p> <p>Clause 9 of the bill seeks to repeal section 17D(6)(a) with the intended effect that a connected person (of an issuer of RCS) who is chargeable to profits tax in respect of a sum payable in respect of the RCS, would be considered a “specified connected person” and thus chargeable to profits tax under section 17D. Please clarify whether the removal of section 17D(6)(a) could result in double taxation on a specified connected person (of an issuer of RCS) who could be subject to profits tax in respect of the RCS under other provisions of Part 4 as well.</p>	<p>The removal of section 17D(6)(a) would not result in double taxation on the specified connected person (of an issuer of RCS) in respect of the RCS under the provisions of Part 4. Section 17D is not a charging provision. The effect of section 17D(2) is that any unrealized gain or loss (calculated on fair value basis), which is recognized in the taxpayer’s profit or loss account in accordance with the relevant financial reporting standard, would not be brought into account in computing the taxpayer’s chargeable profits. In other words, any profits or loss arising from RCS would only be taxed or deducted on a realization basis. Sections 17D(3) and (4) provide that any sum arising from conversion to equity, write-down or write-up of RCS would not be treated as trading receipts or deductible for tax purpose. Both sections would not result in double taxation.</p>
5.	<p><u>Clause 11 – section 17F amended (financial institution: issuer’s deduction if RCS is issued to , held by, or issued to or held for benefit of specified connected person)</u></p> <p>Under the proposed amendment to section 16, interest payable on money borrowed by a LAC banking entity by way of issuing RCS would be deductible for ascertaining chargeable profits (proposed section 16(2)(ab)). Section</p>	<p>The amended section 17D works in symmetry with section 17C such that any fluctuation in fair value, conversion to equity, write-down or write-up of the RCS would be disregarded in ascertaining the chargeable profits of both the issuer and the specified connected person of the issuer of the RCS. As such, “specified connected person” should include a connected person who is chargeable to profits tax in Hong Kong. Otherwise, section 17D could not serve the purpose.</p>

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<p>17F(1) provides that no deduction is allowed to an issuer of a RCS for any sum payable in respect of the RCS if it is issued to, held by or issued or held for the benefit of a specified connected person of that issuer.</p> <p>By virtue of the proposed new section 17F(9A)(a), a connected person who is chargeable to profits tax in respect of a sum payable in respect of the RCS would not be regarded as a specified connected person under section 17F so that interest payable on a RCS is deductible for ascertaining chargeable profits.</p> <p>However, such a connected person would be regarded as a specified connected person under section 17D as amended by clause 9 of the Bill. Please explain the inconsistency in treatment of such kind of connected person under the amended sections 17D and 17F respectively.</p>	<p>On the other hand, the purpose of section 17F is to restrict the issuer's deduction of interest if the RCS is issued to, held by or issued or held for benefit of a specified connected person. If the connected person is chargeable to profits tax in Hong Kong, the interest income received by the connected person would be taxable in Hong Kong. That means, there is symmetry in taxation of interest income and deduction of interest expense. As such, we consider that a restriction on the issuer's deduction of interest expense is not required. Therefore, section 17F is applicable only if the connected person is not chargeable to profits tax in Hong Kong, i.e. the interest income is not taxable in Hong Kong.</p>

**Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
Inland Revenue Department
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