Hong Kong's Qualifying Debt Instrument scheme

by the Monetary Management Department

An active and diverse debt market is important for the further development of Hong Kong as an international financial centre. Hong Kong's Qualifying Debt Instrument scheme, which was implemented in 1996 to develop and enhance the competitiveness of the local debt market, has been refined recently to better achieve its aims. This article explains the QDI scheme and gives a brief overview of the latest refinements.

The Qualifying Debt Instrument scheme

Hong Kong's Qualifying Debt Instrument (QDI) scheme was introduced in 1996 with the policy objectives of attracting overseas issuers to Hong Kong, enlarging the local debt market, and enhancing the competitiveness of Hong Kong vis-à-vis other financial centres in the region. The scheme provides concessionary tax treatment on interest income and trading profits derived from QDIs.

Under the Inland Revenue Ordinance (IRO), interest income and trading profits of debt instruments issued and traded in Hong Kong are chargeable to profits tax. When the QDI scheme was first introduced, a tax concession at 50% of the normal profits tax rate was granted under section 14A of the IRO to interest income and trading profits derived from a debt instrument that satisfied the relevant criteria, including those instruments which –

(a) were lodged with and cleared by the Central Moneymarkets Unit (CMU) operated by the Hong Kong Monetary Authority (HKMA);
(b) had an original maturity of five years or more;
(c) had a minimum denomination of HK$500,000 or its equivalent in a foreign currency;
(d) were issued to the public in Hong Kong; and
(e) had a credit rating acceptable to the HKMA from a credit rating agency it recognised.

For the QDI scheme to achieve its aims, refinements need to be made in response to changing market landscape and measures adopted by other financial centres in the region for developing their respective debt markets. As such, the minimum denomination for debt instruments eligible for the 50% concessionary rate of profits tax was reduced from $500,000 to $50,000 in 1999. In 2003, the 50% profits tax concession was extended to interest income and trading profits derived from QDIs with original maturity period of three years or more, and the profits tax concession was enhanced from 50% to 100% for interest income and trading profits arising from QDIs with an original maturity of at least seven years (long-term debt instruments). It may be worth mentioning here that, in addition to long-term debt instruments, a 100% tax exemption has also been granted, since 1990, to profits tax for interest income and trading profits arising from certain categories of debt instruments specified in section 26A of the IRO. These debt instruments include government bonds, Exchange Fund debt instruments, and Hong Kong dollar denominated multilateral agency debt instruments.

Despite the refinements introduced in 1999 and 2003, the percentage of QDI issuance in Hong Kong's total debt issuance has remained small. In the six years from 2003 to 2009, only about 4% of the total debt issuance was QDIs, which highlighted the need for further improvements to enable the scheme to better serve its policy objectives.

A review was conducted and several areas were identified where the scheme could be improved. First, the structure of the tax incentives offered under the scheme did not match the landscape of Hong Kong's corporate bond market. While this market was dominated by privately placed short-term debt instruments with an original maturity of less than three years (46% of total issuance), the scheme only offered tax incentives to debt instruments with an original maturity of three years or more and which were "issued to the public". Secondly, since the "issued to the public" criterion was not clearly defined in the IRO, there were some uncertainties in the market as to how this criterion should be interpreted in practice. In addition, the eligibility criteria of the scheme appeared to be more stringent than those of similar schemes in other financial centres in the region.[1]

The latest refinements

To address these issues, several refinements to the QDI scheme were included in the Financial Secretary's 2010-11 Budget. The necessary legislative amendments to implement the refinements were enacted in March 2011. These measures, which aim to strike a balance between meeting market development needs and minimising the risk of tax avoidance, are expected to help further develop the local debt market and put Hong Kong on a more equal footing with other financial centres in the region in attracting debt market activities.

1. **Extending tax concessions to short-term debt instruments**

   The 50% tax concession granted under section 14A of the IRO has been extended to interest income and trading profits derived from debt instruments with an original maturity of less than three years.

   This amendment aims to place short-term debt instruments on a level-playing field with longer-term debt instruments for profits tax treatment. As an international financial centre, Hong Kong should aim at developing a debt market that is deep, active and diverse, and with a wide spectrum of participants (including issuers, investors and services providers) as well as issues. This measure is expected to help stimulate new demand for bond issues in Hong Kong.

2. **Replacing the "issued to the public" criterion with a new requirement**

   To remove the uncertainties over what constitutes "issued to the public", a new requirement was introduced that, at issuance, the instrument is issued in Hong Kong to -

   (a) 10 or more persons; or
   (b) if less than 10 persons, none of whom is an associate of the issuer of the instrument.

   The "issued to the public" criterion was introduced to address potential tax avoidance through arranging as QDIs intra-group or inter-group debt issues that were otherwise not necessary to enjoy tax benefits. However, since the IRO did not specify what constituted "issued to the public", the legal uncertainties deterred many debt market participants from using the QDI scheme. This refinement was formulated taking into account the landscape of Hong Kong's debt market and the criterion's original intent of preventing tax avoidance. In drawing up the amendment, reference was made to similar schemes overseas that were considered successful in facilitating the development of the relevant local debt market.[2]

[1] For example, under a similar scheme in Singapore, debt instruments only need to meet certain requirements on the issuer and the arranger and fulfil a clearly defined criterion on "issued to the public" to be eligible for tax concessions under the scheme. No maturity requirement is applied under Singapore's scheme.

[2] Under Singapore's scheme, debt securities are deemed "issued to the public" if they are issued to four persons or more; or have less than 50% of the issue of debt securities being beneficially held or funded by related parties of the issuer of those debt securities at the time of primary launch. If, at any time during the life of an eligible debt issue, 50% or more of the issue is beneficially held or funded, directly or indirectly, by a related party of the issuer, the portion of the issue held by related parties will not be eligible for tax concessions under the scheme. On the other hand, under Australia's scheme, issuers are only required to offer the issue to a specified minimum number of potential investors. No requirement is set on the number of investors to whom the debt securities are ultimately issued.

3. Addition of a further anti-avoidance provision

To provide a further safeguard against potential intra-group tax avoidance arrangements, a new provision has been added that the relevant profits tax concession will not apply to any interest income and trading profits received by or accrued to a person in relation to a QDI if, at the time during which such interest income and trading profits are received or accrued, the person is an associate of the issuer of the QDI.

4. Addition of definition of "associate" and carve-out provision

In connection with the amendments mentioned in points 2 and 3 above, a definition of "associate" has been introduced for the purpose of the QDI scheme. This is in line with similar definitions in existing provisions in the IRO, for example, section 16(3) concerning the ascertainment of chargeable profits. Under such definitions, an "associate" in essence means an entity which controls the issuer, or is subject to control of the issuer, or is subject to the control of the same person as is the issuer, either directly or indirectly. However, having considered the market reality and development direction of Hong Kong, a provision has also been introduced to remove state-owned enterprises meeting certain criteria from this "associate" definition. Without this carve-out provision, the "associate" definition may unduly undermine the participation of some practically non-associated state-owned enterprises in the debt market. These state-owned enterprises may be "associated" merely because of common ownership by the central government of a country or its sovereign wealth funds or similar state-owned enterprises. They may, in practice, operate independently as separate commercial entities. Such a carve-out provision is important to encourage and attract more such state-owned enterprises, including those from the Mainland, to make use of the debt market platform in Hong Kong to meet their financial intermediation needs, either as an issuer or investor. This is consistent with efforts to promote Hong Kong as an international financial centre.

Communication with the market

During the policy review and formulation process, the HKMA maintained close contact with the market through the Treasury Markets Association[3] (TMA), which is generally supportive of the refinements. A briefing on the QDI scheme, including the latest refinements, was also conducted for market participants through the TMA in April 2011. The HKMA will continue its dialogue with market participants and consider further improvements to the scheme as and when appropriate.

Further information

Further details on the latest refinements and the QDI scheme are available on the Inland Revenue Department website (www.ird.gov.hk/eng/tax/bus_pft.htm#08).

[3] The TMA was set up in November 2005 to promote co-operation among market participants in raising the professionalism of practitioners and the overall competitiveness of the treasury markets in Hong Kong. Specifically, the TMA develops and promotes appropriate codes and standards for treasury markets; promotes market and product development; provides training and accreditation of relevant qualifications; and raises the profile of Hong Kong as the preferred hub for treasury market businesses in the region. The TMA consists of both individual and institutional members from the foreign exchange and money markets, debt, derivatives and other treasury markets.