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**Bills Committee on
Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005**

Background Brief

Purpose

This paper sets out the background of the Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005, and summarizes the major concerns expressed by Members when the relevant proposal was deliberated at the meeting of the Panel on Financial Affairs (FA Panel) on 4 April 2005.

Background

2. Under the existing Inland Revenue Ordinance (IRO) (Cap. 112), any person (both resident and non-resident) deriving trading profits from securities transactions carried out in Hong Kong are liable to pay profits tax. However, other major international financial centres (IFCs) including New York and London as well as the other major player in the region, Singapore, all exempt offshore funds from taxation. To reinforce the status of Hong Kong as an IFC and enhance Hong Kong's competitiveness vis-à-vis other IFCs, the Government proposed in the 2003-04 Budget to exempt offshore funds from profits tax. According to the Administration, the proposal would help to attract new offshore funds to Hong Kong and encourage existing offshore funds to continue to invest in Hong Kong. Anchoring offshore funds in Hong Kong markets could also help maintain international expertise, promote new products, and further develop the local fund management industry.

3. The Administration conducted two rounds of consultation with the fund industry, interested parties and the public in early 2004 and early 2005 respectively on the approach for effecting the proposal of providing profits tax exemption for offshore funds. At the FA Panel meeting on 4 April 2005, Members were briefed on the proposal and outcome of the consultation. Members noted that respondents generally considered that the Administration's approach was the correct approach. The major views and concerns expressed by Members at the Panel meeting are summarized in paragraph 6 below.

4. On 6 July 2005, the Administration introduced the Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005 (the Bill) into the Legislative Council (LegCo). On 8 July 2005, the House Committee decided that a bills committee be formed to study the Bill.

Objectives of the Bill

5. The Bill seeks to amend IRO to give effect to the proposal of providing profits tax exemption for offshore funds. The Bill contains two main sets of provisions, as follows:

(a) Exemption provisions

These are provisions for exempting non-resident entities (which can be individuals, partnerships, trustees of trust estates or corporations administering a fund) from tax for profits derived from "qualified transactions" carried out in Hong Kong, including dealings in securities, dealings in futures contracts and leveraged foreign exchange trading as defined in the Securities and Futures Ordinance (SFO) (Cap. 571). To qualify for the exemption, the transactions must be carried out by specified persons, which include corporations and authorized financial institutions licensed or registered under the SFO to carry out such transactions. The offshore funds must not carry on any other business (except transactions incidental to the qualified transactions) in Hong Kong. It is proposed that the exemption provisions will apply with retrospective effect to the year of assessment commencing on 1 April 1996.

(b) Deeming provisions

These are specific anti-avoidance provisions to prevent abuse or round-tripping by local funds disguised as offshore funds seeking to take advantage of the exemption. A resident entity directly or indirectly holding 30% or more of beneficial interest (the 30% threshold) in a tax-exempt offshore fund will be deemed to have derived assessable profits in respect of profits earned by such offshore fund from qualified transactions and incidental transactions in Hong Kong. The deeming provisions will not apply if the offshore fund is bona fide widely held; or the resident (alone or with his associates) holds less than 30% of the offshore fund unless such offshore fund is his associate.

Members' major views and concerns expressed at Panel meeting

6. At the FA Panel meeting on 4 April 2005, while majority of the members present at the meeting supported the Administration's proposal in principle, one member indicated that he objected to the proposal in principle and some members raised concerns about the exemption provisions and deeming provisions. The major views and concerns expressed at the meeting are summarized as follows:

- (a) The Administration should quantify the economic benefits of the proposal and provide information on the financial implications of the proposal, in particular the estimated amount of tax revenue foregone;
- (b) Given that the proposal of exempting offshore funds from profits tax would make offshore funds more attractive to investors, concern was raised on whether the proposal would put onshore funds in a less favourable position;
- (c) On the Administration's proposal to apply the proposed exemption with retrospective effect to the year of assessment commencing on 1 April 1996, concern was raised on the impact of the proposal on tax revenue and whether the Government would be required to refund the profits tax collected from offshore funds since 1 April 1996. As a matter of principle, legislative provisions should take effect from the enactment of the legislation and should not have retrospective effect;
- (d) The proposed deeming provisions might have negative impact on Hong Kong residents. By virtue of the deeming provisions, Hong Kong residents directly or indirectly held 30% or more of the beneficial interest in a tax-exempt non-resident entity would be

deemed to have derived assessable profits in respect of profits earned by the non-resident from exempted securities trading transactions in Hong Kong and thus liable to pay profits tax; and

- (e) There was concern about the effectiveness of the proposed 30% threshold in preventing abuse by local funds and other entities to take advantage of the exemption provisions to evade from profits tax liability, and the justifications for proposing a 30% threshold and whether a higher threshold should be set.

7. An extract from the minutes of the FA Panel meeting on 4 April 2005 is in **Appendix I**. To address the concerns raised at the meeting, the Administration provided a supplementary information paper after the meeting. The paper is in **Appendix II**.

References

8. A list of relevant papers is set out in **Appendix III**.

Council Business Division 1
Legislative Council Secretariat
14 July 2005

**Extract from the minutes of meeting
of the Panel on Financial Affairs on 4 April 2005**



IV. Briefing on the legislative proposal to provide profits tax exemption to offshore funds

(LC Paper No. CB(1)1160/04-05(03) — Paper provided by the Administration)

Briefing by the Administration

7. At the Chairman's invitation, the Secretary for Financial Services and the Treasury (SFST) briefed members on the background of the Administration's proposal of implementing profits tax exemption for offshore funds (the profit tax exemption proposal). He highlighted the following points:

- (a) Financial services industry was playing an increasingly important role in Hong Kong's economy, and asset management service was an important sector of the industry. Hong Kong had become a key asset management centre in Asia. In 2003, the total assets in fund management business in Hong Kong amounted to \$2,950 billion, of which \$1,860 billion or 63% originated from overseas investors.
- (b) There was good prospect for the development of asset management business in Hong Kong given the presence of favourable factors, including high savings rate in Asia, good prospects for economic growth in the region, and the Mainland policies towards broadening the scope of investment. To capitalize on the opportunities ahead and to reinforce the status of Hong Kong as an international financial centre (IFC), the Government proposed in the 2003-04 Budget to exempt offshore funds from profits tax. The proposal would help attract new offshore funds to Hong Kong and encourage existing offshore funds to continue to invest in Hong Kong. Anchoring offshore funds in Hong Kong markets could also help maintain international expertise, promote new products, and encourage investments in the local fund management industry. In terms of tax treatment for offshore funds, major financial centres including New York and London as well as Hong Kong's major competitor in Asia, Singapore, all exempt offshore funds from taxation.

- (c) The profits tax exemption proposal, if implemented, would make Hong Kong's tax treatment for offshore funds more favourable than other IFCs such as the United States (US), the United Kingdom (UK) and Singapore. At present, Singapore imposed a 20% threshold on the resident interest in offshore funds in order to qualify for exemption whereas both US and UK did not impose threshold requirements.
- (d) The Administration had conducted two rounds of consultation with the industry and interested parties in early 2004 and early 2005 respectively on the approach for effecting the profits tax exemption proposal. Respondents generally considered that the Administration's proposed approach was the correct approach. The proposed legislative amendments had taken into account the views received from the two consultation exercises. The Administration planned to introduce a bill to LegCo in the 2004-05 session to amend the Inland Revenue Ordinance (IRO) (Cap. 112) for implementing the proposal (the Bill).

8. The Deputy Commissioner of Inland Revenue (DC/IR) then briefed members on the proposal. He highlighted the following points:

- (a) Under section 14 of IRO, a person carrying on a trade, profession or business in Hong Kong was chargeable to profits tax in respect of assessable profits arising in or derived from that trade, profession or business. This requirement had no regard to the residency of the person. Where a person was a non-resident and the business was carried on through an agent, section 20A of IRO provided that the non-resident could be charged to tax in the name of the agent and the tax could be recovered from the agent unless the agent was relieved from such liability under section 20AA of IRO. However, this section did not exempt any possible profits tax liability of the non-resident clients themselves.
- (b) Certain specified investment funds were currently exempted from profits tax under section 26A(1A) of IRO. These included mutual funds, unit trusts and similar investment schemes authorized under SFO or where the Commissioner of Inland Revenue (C of IR) was satisfied that they were bona fide widely held investment schemes which complied with the requirements of a supervisory authority within an acceptable regime. However, quite a number of offshore funds did not fall within the ambit of section 26A(1A) and therefore could not enjoy exemption.
- (c) To provide profits tax exemption for offshore funds, the Administration proposed to introduce two sets of provisions to IRO - the Exemption Provisions and the Deeming Provisions, as follows:

Exemption Provisions

- (i) The purpose of the exemption provisions was to exempt a non-resident person from profits tax in respect of any income derived from securities trading transactions undertaken in Hong Kong through an agent who was a broker or an approved investment adviser falling within section 20AA of IRO. The proposed qualifying conditions for the exemption provisions were set out in paragraph 9 of the Administration's paper.

Deeming Provisions

- (ii) To implement the exemption, there was a need to put in specific anti-avoidance provisions to prevent abuse or round-tripping by local funds and other entities disguised as offshore funds or other entities to take advantage of the exemption.
- (iii) The proposed deeming provisions would deem a Hong Kong resident holding a beneficial interest in a tax-exempt non-resident to have derived assessable profits in respect of profits earned by the non-resident from exempted securities trading transactions in Hong Kong. The amount of the deemed assessable profits would be ascertained by taking into account the percentage of the resident's beneficial interest and the length of ownership within the basis period of the relevant year of assessment, irrespective of whether the profits had been distributed to the resident. The resident beneficial owner would have the duty to report the deemed assessable profits to the Inland Revenue Department (IRD).
- (iv) The application of the Deeming Provisions would be restricted to the following situations -
- funds that were not bona fide widely held;
 - a Hong Kong resident, alone or with his associates, whether resident or non-resident, directly or indirectly held 30% or more of the beneficial interest in a tax-exempt non-resident entity (the 30% threshold); and
 - a Hong Kong resident directly or indirectly held any percentage of the beneficial interest in a tax-exempt non-resident entity which was his associate.
- (v) The Administration proposed that the Exemption Provisions should apply with retrospective effect to the year of assessment commencing on 1 April 1996, while the Deeming Provisions should take effect upon enactment of the Bill.

Discussion

Benefits and financial implications of the profits tax exemption proposal

9. Ms Emily LAU considered that a number of proposals put forward by the Administration recently, including the profits tax exemption proposal and the proposal of abolishing the estate duty, would only benefit the middle and the wealthy classes. She expressed dissatisfaction that the Administration had not proposed concrete measures to address the needs and concerns of the less privileged class and alleviate their poverty. Ms LAU urged the Administration to devise concrete measures to address the problems faced by the less privileged class and deploy part of the accumulated surplus of EF for the benefit of the general public.

10. SFST stressed that both the profits tax exemption proposal and the proposal of abolishing the estate duty aimed at enhancing Hong Kong's competitiveness as an asset management centre and reinforcing its status as an IFC. The two proposals would promote the financial services industry and would be beneficial to the development of Hong Kong's economy in the long run, and would not have any negative impact on the less privileged class. As regards concrete measures to meet the needs of the less privileged class, SFST said that the issue should be discussed in the context of the debate on the 2005-06 Budget. In this connection, Ms Emily LAU stressed the importance for the Administration to adopt a comprehensive approach in formulating public policies and assessing the impact of the policies on various sectors of the community before implementing the policies.

11. Mr SIN Chung-kai considered that while the profits tax exemption proposal would benefit Hong Kong's economy, the proposal merited detailed study. To facilitate members' consideration of the proposal, Mr SIN, Ms Emily LAU and Mr Albert HO considered that the Administration should quantify the economic benefits of the proposal, including the estimated number of jobs to be created for the financial services sector and other sectors, and other benefits for the economy of Hong Kong. They also considered that the Administration should provide information on the financial implications of the proposal, including the estimated amount of tax revenue foregone.

12. SFST re-iterated that the profits tax exemption proposal would enhance Hong Kong's competitiveness vis-à-vis other financial centres to help attract new offshore funds to Hong Kong and encourage existing offshore funds to continue to invest in Hong Kong. Continuous development of the fund industry in Hong Kong would help maintain international expertise, promote Hong Kong's financial markets and reinforce Hong Kong's position as an IFC. As regards the financial implications of the proposal, SFST advised that given that only a small amount of profits tax had been collected from offshore funds in the past, it was believed that the proposal would not have significant impact on government revenue. DC/IR supplemented that offshore funds were required to report any assessable profits arising from their business in Hong Kong for taxation purpose. However, IRD had

received very few tax returns from offshore funds in the past. Thus, it did not have sufficient information for assessing the financial implications of the current proposal.

13. Noting the Administration's advice that only a small amount of profits tax had been collected from offshore funds in the past, Ms Emily LAU was concerned about the need for the Administration to put forward the current proposal to exempt offshore funds from profits tax. She was also concerned whether IRD had taken effective enforcement actions to recover the profits tax payable by offshore funds. Ms LAU, Mr SIN Chung-kai and Mr Albert HO considered it essential for the Administration to provide the requested information mentioned in paragraph 11 above so as to facilitate members' consideration of the proposal. The Chairman requested the Administration to provide the information. SFST pointed out that it was difficult to compile the information, and yet the Administration would try its best.

(Post-meeting note: The information provided by the Administration was circulated to members and non-Panel Members vide LC Paper No. CB(1)1425/04-05(02) on 3 May 2005.)

Impact of the profits tax exemption proposal on investors of onshore and offshore funds

14. Mr James TIEN enquired about the impact of the proposal on investors of onshore funds. Given that the proposal would make offshore funds more attractive to investors, Mr TIEN was concerned whether it would put onshore funds in a less favourable position.

15. In response, SFST said that Hong Kong had put in place a simple tax regime with low tax rates. At present, the vast majority of investment funds invested by local investors were exempted from profits tax under IRO. Such funds included mutual funds, unit trusts and similar investment schemes authorized under SFO, or where the C of IR was satisfied that they were bona fide widely held investment schemes which complied with the requirements of a supervisory authority within an acceptable regime. As such, investment incomes of Hong Kong residents generated from these funds, regardless of whether they were onshore or offshore funds, were not liable to profits tax. The onshore funds which were not exempted mainly included institutional funds and corporate or private client portfolios that were not offered to the public. There had been views from the funds industry that the Administration should extend the exemption proposal to cover non-exempted onshore funds. However, the Administration considered that this might have implication on tax revenue. SFST also pointed out that Hong Kong's tax treatment of incomes derived from onshore funds compared favourably with other jurisdictions, such as UK and Singapore, in which investment incomes of residents were generally liable to income tax. In other major IFCs, preferential tax treatment was usually made available only to public funds that were widely held, but rarely to privately held funds. The existing practice in Hong Kong was therefore in line

with international practices.

16. DC/IR added that in order to facilitate implementation of the proposal, the Bill would include provisions on definitions of key terms such as “resident” and “non-resident” in respect of individuals, partnerships, corporations and trustees etc.. These definitions would apply for the purpose of the proposed profits tax exemption and would have no effect on other provisions of IRO. References would be made to the definitions adopted for the relevant terms in the agreements signed between Hong Kong and other jurisdictions for the avoidance of double taxation. In this connection, Miss Mandy TAM expressed support for using internationally adopted definitions for the key terms in the Bill.

Operation of the Exemption Provisions

17. In response to members’ enquiry about the scope of activities of offshore funds eligible for exemption under the proposal, DC/IR explained that only profits derived from the securities trading transactions undertaken in Hong Kong would be exempted. The scope of “securities trading transactions” would cover dealings in securities, futures contracts, foreign exchange trading, trading through automated trading services and asset management as defined as Type 1, 2, 3, 7, and 9 Regulated Activities in Schedule 5 to SFO. Responding to Mr Albert HO’s enquiry, DC/IR confirmed that profits derived from real property investments in Hong Kong by offshore funds would not be eligible for exemption.

18. Miss Mandy TAM noted from paragraph 9(iii) of the paper provided by the Administration that there would be provisions in the Bill to dispense with the existing “associate” test and “independent” test in section 20AA of IRO. She enquired about the reason for deleting the two tests and expressed concern about possible difficulties in enforcing section 20A after the deletion.

19. In response, DC/IR explained that the existing section 20A provided that a non-resident carrying on business through an agent could be charged to tax in the name of the agent and that the tax could be recovered from the agent, unless the agent was relieved from such a requirement under section 20AA. To qualify for the relief, certain conditions must be satisfied. These included that the brokers/approved investment advisers must not be the associates of the non-resident clients (i.e. the “associate” test) and must be independent from the non-resident clients (i.e. the “independent” test). As offshore funds would be exempted from profits tax under the current proposal, the tax liability of the agent in respect of the non-resident entity would be removed. Hence the two tests would become redundant and would be deleted.

20. Miss Mandy TAM enquired about the operation of the de minimis rule referred to in paragraph 9(iv) of the paper provided by the Administration. DC/IR explained that in order to qualify for the proposed exemption, one of the conditions was that a non-resident entity should not carry on any other business in Hong Kong. Given that it was not unusual for offshore funds to undertake activities incidental to

the exempted business, the Administration proposed that non-residents deriving income incidental to the exempted business in Hong Kong would not be regarded as carrying on other business in Hong Kong. Exemption for such incidental income would be subject to a de minimis rule, i.e. exemption for profits tax would be provided for the incidental income if such income did not exceed 5% of the total income earned by the non-resident entity in Hong Kong.

Effective date of the Exemption Provisions

21. On the Administration's proposal to apply the Exemption Provisions with retrospective effect to the year of assessment commencing on 1 April 1996, Mr SIN Chung-kai considered the proposal controversial. He requested the Administration to explain the reasons for and financial implications of the proposal. In particular, he was concerned about the impact of the proposal on tax revenue and whether the Government would be required to refund the profits tax collected from offshore funds since 1 April 1996.

22. DC/IR advised that due to the limited information available about offshore funds, IRD had been unable to initiate proactive actions to recover profits tax from offshore funds until 2000. Since 2000, IRD had collected more information and started to recover profits tax payable by offshore funds in respect of the assessable profits arising from their business in Hong Kong. While some of the offshore funds had paid profits tax, some had raised objections to the assessment and their cases were still being processed. In order to be fair to all offshore funds, the Administration proposed to apply the Exemption Provisions with retrospective effect from the financial year 1996-97 to put it beyond doubt that such profits were exempted from profits tax. DC/IR further pointed out that in the absence of relevant statistical figures, it was difficult for the Administration to assess the impact of the proposal on tax revenue. SFST also pointed out that given that profits tax from offshore funds only accounted for a very small share of the tax revenue, the proposal would not have significant impact on government revenue.

23. Mr SIN Chung-kai was not convinced by the Administration's response. He pointed out that it was a common practice for the Administration, in putting forward a legislative proposal to LegCo, to provide the financial implications of the proposal. He considered such information essential to facilitate Members' consideration of the current proposal, in particular on whether the Exemption Provisions should be applied with retrospective effect. Mr SIN requested the Administration to provide information on the estimated amount of tax revenue foregone in two scenarios, i.e. in the scenario where the Exemption Provisions were applied with retrospective effect to the year of assessment commencing on 1 April 1996, and the scenario where the Exemption Provisions were applied without retrospective effect.

(Post-meeting note: The information provided by the Administration was circulated to members and non-Panel Members vide LC Paper No. CB(1)1425/04-05(02) on 3 May 2005.)

24. Mr Albert HO was also not convinced by the Administration's response. He considered that as a matter of principle, legislative provisions should take effect from the enactment of the relevant bill and should not have retrospective effect. For the current case, the crux of the problem was that IRD had not taken effective enforcement actions in the past to recover profits tax from the offshore funds concerned. If the proposed Exemption Provisions were endorsed by LegCo, the provisions should be applied upon enactment of the Bill and there were no strong justifications for applying the provisions with retrospective effect.

25. Mr James TIEN said that he was not aware of any precedent case in which a legislative provision was applied with retrospective effect to such a long period of time. The LegCo Members of the Liberal Party were of the view that the Administration should avoid setting such a precedent which might have implications on other legislative proposals. For the current proposal, given the Administration's advice that the amount of profits tax involved was small, it should not be a matter of concern to the fund industry as to whether the Exemption Provisions would be applied with or without retrospective effect. Mr TIEN considered that the Exemption Provisions, if endorsed by LegCo, should take effect upon enactment of the Bill.

26. SFST pointed out that as IRD was empowered to recover tax payable in the previous six years, the fund industry was concerned that if the Exemption Provisions would be applied without retrospective effect, IRD might recover from offshore funds the profits tax payable before enactment of the Bill. Such uncertainty gave rise to the concern on whether an entry about profits tax liability should be made in the accounts of the offshore funds. To provide certainty that offshore funds would be exempt from any profits tax liability under section 14 of IRO for the financial years since 1996-97, it was proposed that the Exemption Provisions be applied with retrospective effect to the financial year 1996-97. Nevertheless, SFST said that he appreciated members' concern and would take account of their views in finalizing the details of the proposal.

Admin

Application of the Deeming Provisions

27. Mr Ronny TONG indicated that he supported the profits tax exemption proposal in principle. He was however concerned that the Deeming Provisions would have negative impact on Hong Kong residents. He pointed out that currently Hong Kong residents were not liable to pay profits tax in respect of investment incomes derived from onshore or offshore funds if they did not engage in investment activities as a trade, profession or business. However, by virtue of the Deeming Provisions, Hong Kong residents directly or indirectly held 30% or more of the beneficial interest in a tax-exempt non-resident entity would be deemed to have derived assessable profits in respect of profits earned by the non-resident from exempted securities trading transactions in Hong Kong and thus liable to pay profits tax. Mr TONG also doubted the effectiveness of the proposed 30% threshold in preventing abuse by local funds and other entities to take advantage of the Exemption Provisions to evade from profits tax liability.

28. The Chairman and Mr Albert HO also expressed concern about the effectiveness of the Deeming Provisions in preventing abuse by local funds and other entities.

29. Mr LEE Cheuk-yan indicated that he objected to the profits tax exemption proposal in principle. He expressed concern about the difficulties in enforcing the proposed Deeming Provisions where the non-resident entity refused to provide information relating to its assessable profits to the Hong Kong residents concerned. He requested the Administration to provide justifications for proposing the 30% threshold.

30. Mr James TIEN said that LegCo Members of the Liberal Party considered it appropriate to set a higher threshold for applying the Deeming Provisions, such as 50%. He enquired about the reasons for the Administration to propose a 30% threshold.

31. On the concern about the impact of the Deeming Provisions on Hong Kong residents, SFST re-iterated that currently a large number of investment funds were exempted from profits tax under IRO, and Hong Kong residents might make their own choices in the selection of investment funds. DC/IR further advised that the Deeming Provisions would be restricted to funds which were not bona fide widely held. As such, it was unlikely that Hong Kong investors in general would be affected by the Deeming Provisions.

32. DC/IR advised that the 30% threshold was proposed on the basis that a resident holding a 30% beneficial interest in a non-resident entity should not have difficulty in obtaining information from that entity on the latter's assessable profits from exempted business in Hong Kong for the purposes of reporting deemed assessable profits to IRD. SFST pointed out that in considering the threshold to be adopted, the Administration had taken into account the need to prevent abuses of the Exemption Provisions in order to safeguard against revenue losses, and to avoid imposing compliance burden on resident persons. The Administration considered that a 30% threshold was appropriate to strike a proper balance. Nevertheless, it was suggested by a number of respondents in the second round of consultation that the threshold should be increased to 50%. The Administration welcomed Members' views on whether the threshold should be increased.

33. Mr Ronny TONG suggested that the Administration should employ experts to assess the impact of applying different threshold levels for the Deeming Provisions on tax revenue. DC/IR pointed out that owing to the difficulties in obtaining details of the transactions engaged by offshore funds, IRD did not have information on their investment incomes derived from different sources. It was therefore difficult to assess the impact of applying different threshold levels on tax revenue.

Admin

34. SFST said that if Members were in support of the proposal to provide profits tax exemption to offshore funds, the Administration would introduce the Bill to LegCo. If a bills committee was subsequently formed to scrutinize the Bill, he would suggest to the bills committee that experts from the fund industry be invited to explain the relevant details to the bills committee.

Views of the fund industry

35. Miss TAM Heung-man indicated that she supported the profits tax exemption proposal in principle. Responding to Miss TAM's enquiry, SFST advised that the Administration had consulted the fund industry and taken into account their views before arriving at the current proposal. The fund industry generally considered the current proposal acceptable and urged for its early implementation. However, there were some areas in which the fund industry and the Administration held different views, such as the level of threshold to be adopted for the Deeming Provisions.

Conclusion

36. There being no further questions from members, the Chairman concluded the discussion. He said that a great majority of the members present supported in principle the Administration's proposal to provide profits tax exemption to offshore funds. However, given that members had raised various concerns about the proposed Exemption and Deeming Provisions, the Chairman requested the Administration to provide the following information to address their concerns:

- (a) The operation of offshore funds in Hong Kong;
- (b) The operation of the existing provisions of IRO relating to profits tax liability and exemption for offshore funds and onshore funds, including the effect of the provisions on resident and non-resident investors (including individuals, partnerships, trusts and corporations) of the funds;
- (c) The operation of the proposed Exemption Provisions in respect of offshore funds, including the effect of the provisions on resident and non-resident investors (including individuals, partnerships, trusts and corporations) of the funds;
- (d) The operation of the proposed Deeming Provisions in order to -
 - (i) prevent abuse of the exemption or round-tripping; and
 - (ii) address the concern about the beneficial owners of a fund concealing their interests in the fund to circumvent the proposed 30% threshold.

(Post-meeting note: The information provided by the Administration was

circulated to members and non-Panel Members vide LC Paper No. CB(1)1425/04-05(02) on 3 May 2005.)

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Council Business Division 1
Legislative Council Secretariat
3 June 2005

**Legislative Council Panel on Financial Affairs
Meeting on 4 April 2005**

List of follow-up actions

Legislative Proposal to Provide Profits Tax Exemption to Offshore Funds

At the meeting of the Panel on Financial Affairs on 4 April 2005, the Administration was requested to provide additional information to facilitate Members' understanding of the above proposal. The requested information is set out in the ensuing paragraphs.

Existing legislation and its effects on the operation of offshore funds, onshore funds and their investors

2. An offshore fund is a non-resident of Hong Kong. It may take the form of a trust, a corporation, a partnership or even an individual¹. The holders of the beneficial interests of the offshore fund (the beneficiaries in the case of a trust, shareholders of a corporation, or partners of a partnership) may or may not include residents of Hong Kong. It is theoretically possible for an offshore fund to be wholly-owned by residents of Hong Kong. An onshore fund is a resident of Hong Kong.

3. The trading of listed securities in Hong Kong can amount to the carrying on of a trade, profession or business, and profits derived by the person trading in the securities can be chargeable to profits tax under the Inland Revenue Ordinance (Cap. 112) (IRO). The tax liability is the same

¹ Where the fund takes the form of a corporation, a partnership or a trust estate, its residence [or the trustees' residence in the case of a trust estate] is the place where the central management and control of the corporation, partnership or trust estate is located. This normally means the place where the board of directors, partners or trustees hold meetings. Where the fund is [operated by] an individual, the individual [or the fund] is a resident if (i) he ordinarily resides in Hong Kong; or (ii) stays in Hong Kong for a period [or periods] amounting to more than 180 days during the relevant year of assessment or for a period [or periods] amounting to more than 300 days in 2 consecutive years of assessment one of which is the relevant year of assessment.

without regard to the person's residency.

4. On the other hand, the beneficial owners (i.e. the investors), irrespective of their residency, are not taxed on the distributions/dividends/capital gains they derive from the person trading in the securities. However, in practice, any such gains received by the beneficial owners should have taken into account the profits tax paid by that person.

5. Some examples illustrating the tax liabilities of onshore/offshore funds and their beneficial owners are set out at *Annex A*.

Operation of the proposed exemption provisions and deeming provisions

6. Details of the operation of the proposed exemption provisions and deeming provisions are set out in paragraphs 8 to 11 of the paper for the Panel on 4 April 2005. Some examples illustrating the operation of the exemption provisions and deeming provisions are at *Annex B*.

7. It should be noted that through the deeming provisions, resident investors would not be able to abuse the exemption by round-tripping, i.e. investing in offshore funds to take advantage of the exemption, as they would need to report the deemed profits tax liabilities as beneficial owners of the tax-exempt offshore funds. To combat abuse, in theory, a resident holding any percentage in a tax-exempt non-resident should be caught by the deeming provisions. However, recognising the possible difficulties a resident investor holding a small interest in an offshore fund might face in obtaining information from the fund to report to the Inland Revenue Department (IRD), we have proposed that the deeming provision would not apply if a resident together with his associates, whether resident or non-resident, directly or indirectly holds less than 30% of the beneficial interest in the tax-exempt offshore funds. The interests of associates are taken into account to address the possible abuse by a resident investor concealing his interests in a tax-exempt offshore fund by deliberately distributing these among associated parties to avoid being caught by the deeming provisions. That said, the deeming provision also applies to a resident who directly or indirectly holds any percentage of the beneficial interest in a tax-exempt offshore fund which is his associate because the resident should have no difficulty in obtaining

information from his associate. Examples demonstrating how the deeming provisions could prevent abuse are at *Annex C*.

Economic benefits and financial implications of the proposal

8. According to the Securities Futures Commission (SFC), 63% of the total assets in the fund management business (amounting to \$1,860 billion) in 2003 were sourced from overseas investors². The proposed exemption would help to attract new offshore funds to Hong Kong and encourage existing offshore funds to continue to stay in Hong Kong.

9. The industry has expressed its view that, due to keen international competition, it is vital for Hong Kong to provide profits tax exemption to offshore funds as for other major financial centres, as otherwise the offshore funds may relocate away from Hong Kong, leading to loss of market liquidity and a negative read-across impact on other financial services, including downstream services such as those provided by brokers, accountants, bankers and lawyers.

10. We have consulted the industry players on the perceived economic benefits of the proposed exemption. It is believed that the proposal would be an impetus to our financial market and the employment market in respect of financial services and related sectors. But it is difficult to quantify such benefits.

11. As regards the financial implications, an offshore fund as a non-resident operates its business outside the jurisdiction of and has no substantive presence in Hong Kong. As explained in the paper for the Panel, due to the difficulties in obtaining details of transactions involving non-resident persons, the IRD is not in a position to enforce the relevant provisions effectively in practice in respect of cases where the persons carrying out securities transactions are non-residents. Besides, even if an assessment is raised on a non-resident, the Administration would have practical difficulty in recovering the tax from the non-resident who is outside the reach of legal action initiated in Hong Kong.

12. In view of the above, we believe that the actual cost to revenue of this proposal should not be significant. In fact, for all past years, only a

² Source of information from SFC's Fund Management Activities Survey 2003.

small amount of tax, in the region of \$18.2 million, has been collected from offshore funds. Assessments for another \$7.5 million have been issued but are still under objection by the offshore taxpayers. We do not know whether this amount would finally be receivable.

13. The proposal for the exemption provisions to take retrospective effect is aimed to provide legal certainty over the tax liability of offshore funds in respect of past years. We understand from the market that, in the absence of the retrospective provisions, there would be huge problems for offshore funds to confirm compliance as far as tax liability is concerned, or the funds' profits or loss for past years.

14. In fact, there are precedents in which legislative amendments for implementing tax concession measures took retrospective effect. One example is the Inland Revenue (Amendment) (No.4) Ordinance 1992 which took retrospective effect from 3 December 1990 to exempt the owners of Hong Kong registered ships from profits tax on income derived from the international operations of those vessels. Another example is the Inland Revenue (Amendment) Ordinance 2004 which added section 70AA to the IRO which allows retrospective revision of an otherwise finalized assessment to take into account relaxed criteria for the deduction of self-education expenses and home loan interest.

15. If the proposed retrospective provision is adopted, we will need to refund the \$18.2 million profits tax collected, which would be relatively insignificant when compared to the proposal's important impact on strengthening Hong Kong's position as an international financial centre and the economic benefits this could bring to the financial services as well as other sectors of the economy in Hong Kong.

Financial Services and the Treasury Bureau

April 2005

Operation of the existing provisions

Example 1: Onshore fund

HK Ltd is a company incorporated and carrying on business in Hong Kong. It is a resident company. In the relevant year of assessment, HK Ltd derived the following profits from securities transactions – (i) trading profits of \$6M from buying and selling listed securities in the Hong Kong Stock Exchange [“HK securities trading profits”]; (ii) a capital gain of \$4M from the sale of listed securities in Hong Kong which have been held as investments [“HK securities capital gain”]; and (iii) trading profits of \$2M from buying and selling listed securities in the New York Exchange [“offshore securities trading profits”].

HK Ltd is chargeable to profits tax on the “HK securities trading profits” of \$6M. The “HK securities capital gain” of \$4M and “offshore securities trading profits” of \$2M are non-taxable.

Example 2: Offshore fund

BVI Ltd is a non-resident company. It derived the same profits from securities transactions as HK Ltd.

As with HK Ltd, BVI Ltd is chargeable to profits tax on the “HK securities trading profits” of \$6M. The “HK securities capital gain” of \$4M and “offshore securities trading profits” of \$2M are non-taxable. In effect, there is no difference between the tax treatment of an onshore fund and an offshore fund.

Example 3: Resident and non-resident investors

Kowloon Ltd is a resident company and UK Ltd a non-resident company. They respectively hold 50% of the shareholding in BVI Ltd. In the relevant year of assessment, they respectively receive dividend of \$1M from BVI Ltd.

Both Kowloon Ltd and UK Ltd are not chargeable to tax in respect of the dividend of \$1M.

Operation of the proposed Exemption Provisions and Deeming Provisions

Example 1: Onshore fund

Facts same as Example 1 in *Annex A*. HK Ltd as a resident company is not entitled to the proposed exemption. There is no change in its tax position. HK Ltd is chargeable to profits tax on the “HK securities trading profits” of \$6M. The “HK securities capital gain” of \$4M and “offshore securities trading profits” of \$2M are non-taxable as before.

Example 2: Offshore fund

Facts same as Example 2 in *Annex A*. BVI Ltd as a non-resident company is entitled to the proposed exemption. The “HK securities trading profits” of \$6M would be exempt from profits tax. The “HK securities capital gain” of \$4M and “offshore securities trading profits” of \$2M are non-taxable as before.

Example 3: Resident and non-resident investors

Facts same as Example 3 in *Annex A*. Kowloon Ltd is a resident company and holds 50% [i.e. exceeds the proposed 30% threshold] of the beneficial interest in BVI Ltd as a tax-exempt non-resident. The Deeming Provisions would be invoked on Kowloon Ltd to impose profits tax on deemed profits of \$3M [50% of the “HK securities trading profits” of \$6M]. The “HK securities capital gain” and the “offshore securities trading profits” all along are non-taxable receipts and would not be included in computing the deemed profits.

The Deeming Provisions would not be invoked on UK Ltd which is a non-resident company. As before, both Kowloon Ltd and UK Ltd are not chargeable to tax in respect of the dividend of \$1M.

Operation of the proposed Deeming Provisions in order to prevent abuse

Example 1: Onshore fund disguised as offshore fund

Lantau Ltd is a resident company. It engages in a brokerage and securities trading business. Its profits from trading in securities listed in Hong Kong are fully taxable. Recognizing the enactment of the proposed exemption, Lantau Ltd set up a wholly owned subsidiary, CI Ltd, in the Cayman Islands to take up its securities trading business. In the relevant year of assessment, CI Ltd derived profits of \$10M from trading in securities listed in Hong Kong.

Without the Deeming Provisions

CI Ltd as a non-resident company is entitled to the proposed exemption. Profits tax is explicitly exempt in respect of the HK securities trading profits of \$10M.

Lantau Ltd is not liable to profits tax in respect of the securities trading transactions in Hong Kong carried out by CI Ltd as a separate entity. Lantau Ltd also is not chargeable to tax in respect of any dividends received from CI Ltd. As a result, the \$10M profits from trading in HK listed securities would escape from the tax net.

With the Deeming Provisions

Same as above, CI Ltd as a non-resident company is entitled to the proposed exemption. Profits tax is explicitly exempt in respect of the HK securities trading profits of \$10M.

Lantau Ltd is a resident company and holds 100% [i.e. exceeds the proposed 30% threshold] of the beneficial interest in CI Ltd as a tax-exempt non-resident. The Deeming Provisions would be invoked on

Lantau Ltd to impose profits tax on deemed profits of \$10M [100% of the “HK securities trading profits” of \$10M]. Despite the Deeming Provisions, any dividends received by Lantau Ltd from CI Ltd would continue to be non-taxable. Hence, no double taxation would arise.

Example 2: prevent circumventing the 30% threshold

HK Ltd, a resident company, holds 20%, whereas US Inc., a non-resident company and the holding company of HK Ltd, holds the remaining 80% of the beneficial interest, in BVI Ltd. BVI Ltd carried out securities trading transactions in Hong Kong and derived profits of \$5M in the relevant year of assessment.

Under the Exemption Provisions, BVI Ltd as a non-resident is exempt from profits tax in respect of the “Hong Kong securities trading profits” of \$5M.

HK Ltd together with US Inc., its non-resident holding company, holds 100% [i.e. exceeds the proposed 30% threshold] of the beneficial interests in the tax-exempt BVI Ltd. Under the Deeming Provisions, profits tax would be charged on HK Ltd in respect of deemed profits of \$1M [20% of the “Hong Kong securities trading profits” of \$5M] even though HK Ltd’s beneficial interest in BVI Ltd is less than 30%.

Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005

List of relevant papers
(Position as at 14 July 2005)

Paper	LC Paper No.
Administration's paper on "Legislative Proposal to Provide Profits Tax Exemption to Offshore Funds"	CB(1)1160/04-05(03) <i>(discussed at the FA Panel meeting on 4 April 2005)</i>
Legislative Council Brief on Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005	File Ref: FIN CR3/7/2201/02 <i>(issued by the Financial Services and the Treasury Bureau on 28 June 2005)</i>
Legal Service Division Report on Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005	LS91/04-05 <i>(issued on 7 July 2005)</i>

Council Business Division 1
Legislative Council Secretariat
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