

Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005
Notes to Deputations on Committee Stage Amendments
Proposed by the Administration

At the invitation of the Bills Committee for the Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005, deputations made representations to the Committee and some attended the 2nd Meeting of the Committee held on 25 October 2005. After taking into account of the industry's feedback, the Administration proposed 9 Committee Stage Amendments (CSAs) which were considered by the Bills Committee in its 3rd meeting held on 28 November 2005. The Bills Committee has decided to invite the aforesaid deputations to give their views on the technical aspects of the Administration's proposed CSAs. The purpose of these notes is to brief the deputations on the amendments proposed in the CSAs and elaborate on the revised scope of exemption contained in the proposal.

As mentioned in the Bills Committee's letter to the deputations dated 6 December 2005, the major proposed CSAs are –

- (a) to expand the scope of exemption to cover 6 types of “specified transactions” that are commonly entered into by offshore funds, including various derivative products in stocks, indices, commodities and others;
- (b) to expand the scope of “specified person” to cover any corporation licensed, or any authorized financial institution registered, under the Securities and Futures Ordinance to carry on a regulated activity; in other words, any licence holder under the SFO will qualify as “specified person”;
- (c) to exempt a “specified transaction” so long as it is “carried out through or arranged by” a “specified person”;
- (d) to carve out “non-profit participating shares” from the application of the Deeming Provisions; and
- (e) to apply the Deeming Provisions with effect from the year of assessment immediately following the year of assessment in which the

Bill is enacted.

As for the revised scope of exemption under the Bill, we attach a detailed paper at the **Appendix** setting out the various types of transactions that are commonly entered into by an offshore fund and their taxation treatment both under the original Bill and under the proposed CSAs.

At the said Bills Committee meeting of 28 November 2005, members examined the Bill clause-by-clause and considered the Administration's proposed amendments, which they supported. They considered that the proposed CSAs had achieved the policy objective of providing profits tax exemption for offshore funds and should have addressed the concerns raised by deputations. The Bills Committee also noted the industry's strong call for early enactment of the Bill and is working on the early resumption of the Second Reading debate on the Bill.

The Administration wishes to reassure you, as the representatives for the industry, that we have considered all your suggestions and comments, and have practically included all commonly traded transactions within the exemption ambit as far as possible. There will only be few exceptions, which mainly relate to transactions in private company shares (or debentures, notes, etc.) or insurance policies, or transactions that amount to the conducting of a money-lending business by the fund. All other common types of transactions will be included in the exemption. The detailed list will be included in the Inland Revenue Department (IRD)'s Departmental Interpretation and Practice Notes to be issued to provide certainty of the IRD's views on the matter. Besides, the Commissioner of Inland Revenue will be empowered to amend the schedule of "specified transactions" by notice in the Gazette to cater for market developments. Therefore, the Administration would earnestly urge you to support the proposed CSAs. Your support will assist in the early passing of the Bill and with it, the legislative certainty for profits tax exemption that goes back to as early as 1996!

If you have any enquiries or need any clarification, the IRD will be pleased to assist. Please contact Mr YY CHU at 2594 1400.

Inland Revenue Department
15 December 2005

Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005
Scope of Exemption

Transactions In	Exempt under the original Bill?	Exempt after the CSAs?
1 Foreign exchange/currencies		
(a) Foreign exchange forwards	Yes (leveraged foreign exchange trading)	Yes. Covered by specified transaction in “foreign exchange contract”. Both leveraged and non-leveraged transactions are covered.
(b) Foreign exchange options	Yes (leveraged foreign exchange trading)	Yes. Covered by specified transaction in “securities” – para. (e). Both leveraged and non-leveraged transactions are covered.
(c) Currency swaps	Yes (leveraged foreign exchange trading)	Yes. Covered by specified transaction in “foreign exchange contract”. Both leveraged and non-leveraged transactions are covered.
(d) Spot foreign exchange transactions	No	Yes. Covered by specified transaction in “foreign currencies”, which include

Transactions In	Exempt under the original Bill?	Exempt after the CSAs?
		transactions of foreign currencies from/to Hong Kong dollars.
(e) Deposits	No	Yes. Covered by specified transaction consisting in “the making of a deposit other than by way of a money-lending business”.
(f) Buying/selling certificates of deposit, bills of exchange and promissory notes	No	Yes. Covered by specified transaction in “securities” – para. (e).
(g) Borrowing/lending money (in any currency, and whether on a secured or unsecured basis) (including participating as a lender in syndicated loans, selling sub-participations in loans to third parties, etc.)	No	No, if the activities amount to the carrying on of a money-lending business similar to a financial institution or a licensed money-lender. Not covered by the proposed exemption as a matter of policy. [Note that the absence of a banking or money-lending licence is not conclusive as to whether or not such a business is being carried on.] The policy objective is to provide profits tax exemption to offshore funds. The normal course of the business of an offshore fund should not include carrying on a money lending business, which is a question of fact.

Transactions In	Exempt under the original Bill?	Exempt after the CSAs?
		However, if the placing of fund is by way of investment, it is covered by the 4 th Specified Transaction.
2 Equities		
(a) Buying/selling listed equities (whether in Hong Kong or elsewhere)	Yes (dealing in securities)	Yes (transaction in “securities” – para. (a))
(b) Buying/selling unlisted equities issued by ‘public’ companies (whether incorporated in Hong Kong or elsewhere)	Yes (dealing in securities)	Yes (transaction in “securities” – para. (a))
(c) Buying/selling Hong Kong private equities	No (these equities are not “securities”)	No. Not covered by the proposed exemption as a matter of policy. A person may in effect trade in any types of assets [e.g. landed property] through transfer of shares in private companies purposely set up for holding such assets. Inclusion of shares in private companies would grant exemption to all sorts of trading transactions. This would unintentionally widen the scope

Transactions In	Exempt under the original Bill?	Exempt after the CSAs?
		of exemption.
(d) Buying/selling equities in private companies incorporated outside Hong Kong	Yes (dealing in securities)	Yes (transaction in “securities” – para. (a))
(e) Stock borrowing and lending and repurchase and reverse-repurchase transactions in equities	Yes (dealing in securities)	Yes (transaction in “securities” – para. (a))
(f) Hedging activities involving buying and selling equities as a hedge to some derivative or other position	Yes (dealing in securities)	Yes (transaction in “securities” – para. (a))
(g) Short selling equities (whether on market or off market)	Yes (dealing in securities)	Yes (transaction in “securities” – para. (a))
3 Equity derivatives		
(a) Buying/selling exchange-traded futures contracts over equities (including equity index products)	Yes (dealing in futures contracts)	Yes (transaction in “futures contracts”)
(b) Buying/selling exchange-traded options	Yes (dealing in futures contracts)	Yes (transaction in “futures contracts”)

Transactions In	Exempt under the original Bill?	Exempt after the CSAs?
on futures contracts over equities (including equity index products)		
(c) Buying/selling exchange-traded stock option contracts over equities (including equity index products)	Yes (dealing in securities)	Yes (transaction in “futures contracts”)
(d) Entering into OTC equity contracts for differences (whether over one or more equities)	Yes (dealing in securities)	Yes (transaction in “futures contracts” – para. (b))
(e) Entering into OTC call/put options over equities (physical delivery) (whether over one or more equities)	Yes (dealing in securities)	Yes (transaction in “securities” – para. (b))
(f) Entering into OTC call/put options over equities (cash settlement) (whether over one or more equities)	Yes (dealing in securities)	Yes (transaction in “futures contracts”)
(g) Entering into OTC forwards over equities (physical delivery) (whether over one or more equities)	Yes (dealing in securities)	Yes (transaction in “securities” – para. (b))
(h) Entering into OTC forwards over	Yes (dealing in securities)	Yes (transaction in “futures contracts” – para

Transactions In	Exempt under the original Bill?	Exempt after the CSAs?
equities (cash settlement) (whether over one or more equities)		(b))
(i) Entering into OTC equity asset swaps, total return swaps, swaptions (whether over one or more equities)	Yes (dealing in securities)	Yes (transaction in “securities” – para. (b))
(j) Buying/selling warrants (whether exchange traded or OTC)	Yes (dealing in securities)	Yes (transaction in “securities” – para. (b))
(k) Entering into OTC swaps of dividend on equities against some other income stream (whether over one or more equities)	Yes (dealing in securities)	Yes (transaction in “securities” – para. (e))
4 Funds		
(a) Buying/selling funds (whether exchange traded or not)	Yes (dealing in securities)	Yes (transaction in “securities” – para. (a))
(b) Buying/selling funds of funds	Yes (dealing in securities)	Yes (transaction in “securities” – para. (a))
(c) Buying/selling hedge funds	Yes (dealing in securities)	Yes (transaction in “securities” – para. (a))

Transactions In	Exempt under the original Bill?	Exempt after the CSAs?
(d) Entering into OTC call/put options over funds (physical delivery) (whether over one or more funds)	Yes (dealing in securities)	Yes (transaction in “securities” – para. (b))
(e) Entering into OTC call/put options over funds (cash settlement) (whether over one or more funds)	Yes (dealing in securities)	Yes (transaction in “futures contracts”)
(f) Entering into OTC forwards over funds (physical delivery) (whether over one or more funds)	Yes (dealing in securities)	Yes (transaction in “securities” – para. (b))
(g) Entering into OTC forwards over funds (cash settlement) (whether over one or more funds)	Yes (dealing in securities)	Yes (transaction in “futures contracts” – para (b))
5 Fixed income		
(a) Buying/selling any listed bonds, debentures or notes (whether in Hong Kong or elsewhere) (including ‘plain vanilla’ bonds, bonds with warrants, convertible bonds, exchangeable bonds, structured notes, asset-backed securities,	Yes (dealing in securities)	Yes (transaction in “securities” – para. (a))

Transactions In	Exempt under the original Bill?	Exempt after the CSAs?
mortgage-backed securities)		
(b) Buying/selling any unlisted bonds, debentures or notes issued by ‘public’ companies (whether incorporated in Hong Kong or elsewhere) (including ‘plain vanilla’ bonds, bonds with warrants, convertible bonds, exchangeable bonds, structured notes)	Yes (dealing in securities)	Yes (transaction in “securities” – para. (a))
(c) Buying/selling any unlisted bonds, debentures or notes issued by Hong Kong private companies (including ‘plain vanilla’ bonds, bonds with warrants, convertible bonds, exchangeable bonds, structured notes)	No	No. Not covered by the proposed exemption as a matter of policy. The intended result of buying/selling shares in private companies may be achieved through arrangements involving bonds / debentures / notes convertible into shares. See item 2(c) above.
(d) Buying/selling any unlisted bonds, debentures or notes issued by private companies incorporated outside Hong Kong (including ‘plain vanilla’ bonds, bonds with warrants, convertible bonds,	Yes (dealing in securities)	Yes (transaction in “securities” – para. (a))

Transactions In	Exempt under the original Bill?	Exempt after the CSAs?
exchangeable bonds, structured notes)		
(e) Stock borrowing and lending and repurchase Stock borrowing and lending and repurchase and reverse-repurchase transactions in any bonds, debentures or notes	Yes (dealing in securities)	Yes (transaction in “securities” – para. (a))
(f) Hedging activities involving buying and selling any bonds, debentures or notes as a hedge to some derivative or other position	Yes (dealing in securities)	Yes (transaction in “securities” – para. (a))
(g) Short selling any bonds, debentures or notes (whether on market or off market)	Yes (dealing in securities)	Yes (transaction in “securities” – para. (a))
6 Fixed income derivatives		
(a) Entering into OTC call/put options over bonds, debentures or notes (physical delivery) (whether over one or more bonds, debentures or notes)	Yes (dealing in securities)	Yes (transaction in “securities” – para. (b))

Transactions In	Exempt under the original Bill?	Exempt after the CSAs?
(b) Entering into OTC call/put options over bonds, debentures or notes (cash settlement) (whether over one or more bonds, debentures or notes)	Yes (dealing in securities)	Yes (transaction in “futures contracts”)
(c) Entering into OTC forwards over bonds, debentures or notes (physical delivery) (whether over one or more bonds, debentures or notes)	Yes (dealing in securities)	Yes (transaction in “securities” – para. (b))
(d) Entering into OTC forwards over bonds, debentures or notes (cash settlement) (whether over one or more bonds, debentures or notes)	Yes (dealing in securities)	Yes (transaction in “futures contracts” – para (b))
(e) Entering into OTC bond, debenture or note asset swaps, total return swaps, swaptions (whether over one or more bonds, debentures or notes)	Yes (dealing in securities)	Yes (transaction in “securities” – para. (b))
(f) Entering into OTC swaps of interest paid on bonds, debentures or notes	Yes (dealing in securities)	Yes (transaction in “securities” – para. (e))

Transactions In	Exempt under the original Bill?	Exempt after the CSAs?
against some other income stream (whether over one or more bonds, debentures or notes)		
(g) Entering into OTC credit default swaps (physical delivery of the underlying reference obligations)	No (unless reference obligations themselves are or include bonds, debentures or notes, in which case, yes – dealing in securities)	Yes (transaction in “securities” – para. (e))
(h) Entering into OTC credit default swaps (cash settled)	No	Yes (transaction in “securities” – para. (e))
(i) Buying/selling credit-linked notes (whether listed or unlisted)	Yes (dealing in securities)	Yes (transaction in “securities” – para. (a))
(j) Buying/selling collateralised debt obligations	Yes (dealing in securities)	Yes (transaction in “securities” – para. (a))
7 Interest rate derivatives		
(a) Entering into OTC interest rate swaps (whether fixed rate v fixed rate, fixed rate v floating rate, or floating rate v floating rate)	No (unless also some currency element to the swap in which case it might be leveraged foreign exchange trading)	Yes (transaction in “securities” – para. (e))

Transactions In	Exempt under the original Bill?	Exempt after the CSAs?
(b) Entering into OTC interest rate options, swaptions, caps, collars, floors, etc.	No (unless also some currency element to the swap in which case it might be leveraged foreign exchange trading)	Yes (transaction in “futures contract” – para. (b))
8 Commodities		
(a) Buying/selling commodities (physical delivery)	No	Yes. Covered by specified transaction in “exchange-traded commodities” [buying/selling gold and silver through the Hong Kong Gold and Silver Exchange Society]. Overseas transactions in exchange-traded commodities (physical delivery) would only give rise to non-taxable offshore profits.
(b) Buying/selling exchange-traded futures contracts over commodities (including commodity index products)	Yes (dealing in futures contracts)	Yes (transaction in “futures contracts”)
(c) Buying/selling exchange-traded options on futures contracts over commodities (including commodity index products)	Yes (dealing in futures contracts)	Yes (transaction in “futures contracts”)
(d) Entering into OTC commodity contracts for differences (whether over one or	No	Yes (transaction in “futures contracts” – para. (b))

Transactions In	Exempt under the original Bill?	Exempt after the CSAs?
more commodities)		
(e) Entering into OTC call/put options over commodities (physical delivery) (whether over one or more commodities)	No	Yes (transaction in “securities” – para. (e))
(f) Entering into OTC call/put options over commodities (cash settlement) (whether over one or more commodities)	No	Yes (transaction in “futures contracts”)
(g) Entering into OTC forwards over commodities (physical delivery) (whether over one or more commodities)	No	Yes (transaction in “securities” – para. (e))
(h) Entering into OTC forwards over commodities (cash settlement) (whether over one or more commodities)	No	Yes (transaction in “futures contracts” – para. (b))
(i) Entering into OTC commodity asset swaps, total return swaps, swaptions (whether over one or more	No	Yes (transaction in “securities” – para. (e))

Transactions In	Exempt under the original Bill?	Exempt after the CSAs?
commodities)		
9 Other derivatives		
(a) Buying/selling insurance policies	No	No. Not covered by any “specified transaction”. An insurance policy is presently not an investment “commonly known as securities”.
(b) Entering into OTC energy derivatives (e.g. over electricity supply/capacity)	No	Yes. Should be covered by the definition of “securities” – para. (e) if there is physical delivery of the electricity supply, etc. Otherwise covered by specified transaction in “futures contract” – para. (b).
(c) Entering into OTC weather derivatives	No	Yes (transaction in “futures contracts” – para. (b))
(d) Entering into OTC freight derivatives	No	Yes (transaction in “futures contracts” – para. (b)) May also constitute a transaction in “securities” – para. (e) if there is physical delivery.

Transactions In	Exempt under the original Bill?	Exempt after the CSAs?
(e) Entering into OTC derivatives over insurance policies	No	No, for the same reason as given in item 9(a) above.
(f) Entering into OTC derivatives over inflation rates and economic statistics	No	Yes (transaction in “futures contracts” – para. (b))
(g) Entering into derivatives on derivatives	Maybe, depending on the terms of the particular transaction	Yes. Should be covered by the definition of “securities” – para. (e).

Note: Unless otherwise stated, all shares, stocks, bonds, debentures, notes or other equities are not those in or in respect of Hong Kong private companies.