

立法會
Legislative Council

LC Paper No. LS91/04-05

**Paper for the House Committee Meeting
on 8 July 2005**

**Legal Service Division Report on
Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005**

I. SUMMARY

- 1. Objects of the Bill** To amend the Inland Revenue Ordinance (Cap. 112) to give effect to the proposal to exempt offshore funds from profits tax in the Budget for the 2003-2004 financial year and to make related amendments.
- 2. Comments** Under the Bill, it is proposed that –

 - (a) offshore funds are eligible for profits tax exemption if:
 - (i) their profits are derived from qualified transactions carried out in Hong Kong through specified persons licensed or registered under the Securities and Futures Ordinance (Cap. 571); and
 - (ii) the offshore funds concerned do not carry on any other business in Hong Kong;
 - (b) where a resident person holds 30% or more of the beneficial interest in a tax-exempt offshore fund, the assessable profits of the offshore fund from qualified transactions carried out in Hong Kong will be regarded as the assessable profits of the resident person; and
 - (c) the proposed tax exemption will apply with retrospective effect from the year of assessment commencing on 1 April 1996.
- 3. Public Consultation** The Administration has conducted two rounds of consultation with the industry, interested parties and the public in early 2004 and early 2005.
- 4. Consultation with LegCo Panel** The LegCo Panel on Financial Affairs was consulted at its meeting on 4 April 2005. Members raised various concerns on the proposal.
- 5. Conclusion** The Bill will have implications on investors, the financial services industry and the economy of Hong Kong. Members are recommended to form a Bills Committee to examine it.

II. REPORT

Objects of the Bill

To amend the Inland Revenue Ordinance (Cap. 112) to give effect to the proposal to exempt offshore funds from profits tax in the Budget introduced by the Government for the 2003-2004 financial year and to make related amendments.

LegCo Brief Reference

2. File Ref.: FIN CR3/7/2201/02 issued by the Financial Services and the Treasury Bureau on 28 June 2005.

Date of First Reading

3. 6 July 2005.

Comments

4. Under section 14 of the Inland Revenue Ordinance (Cap. 112) (“IRO”), a person (both resident and non-resident) carrying on a trade, profession or business in Hong Kong is chargeable to profits tax in respect of assessable profits arising in or derived from that trade, profession or business. The trading of listed securities in Hong Kong can amount to the carrying on a trade or business under section 14, and profits derived by the person trading in the securities are therefore chargeable to profits tax under IRO.

5. At present, certain investment funds are exempt from profits tax under section 26A(1A) of IRO. These include mutual funds, unit trusts and similar investment schemes authorized as collective investment schemes under the Securities and Futures Ordinance (Cap. 571) (“SFO”), or where the Commissioner of Inland Revenue (“the Commissioner”) is satisfied that they are bona fide widely held investment schemes which comply with the requirements of a supervisory authority within an acceptable regulatory regime. According to the Administration, quite a number of offshore funds investing in Hong Kong do not fall within the ambit of section 26A(1A) of IRO and therefore are liable to pay profits tax in Hong Kong. However, in other major financial centres such as New York and London, offshore funds are exempt from taxation.

6. In order to reinforce the status of Hong Kong as an international financial centre and enhance its competitiveness with other international financial centres, the Government proposed in the 2003-2004 Budget to exempt offshore funds from profits tax (paragraph 97 of the 2003-2004 Budget Speech). According to the LegCo Brief, the proposal would help attract new offshore funds to Hong Kong and encourage existing ones to continue to invest in Hong Kong.

7. The main purpose of this Bill is to amend IRO to give effect to the above proposal.

8. Clause 2 of the Bill adds four new sections, namely, sections 20AB to 20AE, to IRO. The proposed section 20AC (“the exemption provision”) seeks to exempt offshore funds from profits tax. To qualify for the exemption, the following conditions have to be met:

- (a) The profits are derived from qualified transactions undertaken in Hong Kong by a non-resident person, who can be individuals, partnerships, trustees of trust estates or corporations administering a fund. The criteria for determining the residence of individuals, corporations, partnerships and trustees are set out respectively in the proposed section 20AB(2)(a) to (d);
- (b) the scope of qualified transactions covers dealings in securities, dealings in futures contracts and leveraged foreign exchange trading as defined in SFO;
- (c) the qualified transactions must be carried out through specified persons which include corporations and authorized financial institutions licensed or registered under SFO to carry out such transactions; and
- (d) the offshore funds must not carry on any other business (except business incidental to the qualified transactions) in Hong Kong.

9. To prevent abuse or round-tripping by local funds disguised as offshore funds seeking to take advantage of the proposed exemption, the Administration considers it necessary to include anti-avoidance provisions in the Bill. Under the proposed section 20AE (“the deeming provision”), where a resident person’s beneficial interest in a tax-exempt offshore fund reaches a specified threshold, the assessable profits of such offshore fund from qualified transactions and incidental transactions carried out in Hong Kong are to be regarded as the assessable profits of the resident person. The amount so regarded as assessable profits under this provision will be computed by taking into account the percentage of the resident person’s beneficial interest and the length of ownership within the relevant year of assessment, irrespective of whether the profits have been distributed to the person. However, the deeming provision will not apply if the Commissioner is satisfied that the offshore funds are bona fide widely held, or if a resident person (alone or with his associates) holds less than 30% of the offshore fund concerned unless such offshore fund is his associate. The effect of this provision, if enacted, is that a local resident who invests in bona fide widely held offshore funds or who holds a beneficial interest lower than 30% in an offshore fund (provided that the offshore fund is not his associate) will be exempt from profits tax.

10. The Bill also proposes other related amendments including those relating to revision of a tax assessment necessitated by the commencement of the proposed exemption provision following the enactment of the Bill.

11. If the Bill is enacted, the exemption provision will apply with retrospective effect from the year of assessment commencing on 1 April 1996. The deeming provision will apply in relation to the year of assessment in which the Bill when enacted commences and to subsequent years of assessment. According to the LegCo Brief, it is

necessary to give retrospective effect to the exemption provision in order to provide legal certainty on the tax liability of offshore funds in respect of past years in the light of the industry's concerns that there would be huge problems for offshore funds to finalise their tax liabilities in the absence of retrospective application.

Public Consultation

12. According to the LegCo Brief, the Administration has conducted two rounds of consultation with the industry, interested parties and the public in early 2004 and early 2005 on the approach for effecting the proposed profits tax exemption for offshore funds. A total of 22 submissions were received in the latter consultation exercise. According to the Administration, it has taken on board most of the suggestions of the deputations.

Consultation with LegCo Panel

13. The Administration consulted the Panel on Financial Affairs ("the FA Panel") on the proposed tax exemption at its meeting on 4 April 2005. At the meeting, while most members expressed support for the Administration's proposal in principle, one member indicated his objection and some members raised concerns about the proposal. These concerns include the possible negative impact on local funds and resident persons, the justifications for proposing a 30% threshold on beneficial interest holding triggering the deeming provision, the effectiveness of the proposed 30% threshold in preventing abuse by local funds and other entities to take advantage of the exemption provision to evade profits tax liability, and whether a higher threshold should be set. On the proposed retrospective application of the tax exemption, concerns were raised on the appropriateness of the proposal, 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.

14. To address the concerns of the FA Panel, the Administration has provided supplementary information in LC Paper No. CB(1)1425/04-05(02). The paper was circulated to members of the Panel and non-Panel members on 3 May and 9 May 2005 respectively.

Conclusion

15. The Bill will have implications on investors, the financial services industry and the economy of Hong Kong. It is recommended that a Bills Committee be formed to study the Bill in detail.

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