

**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.

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

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 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

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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%.