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財經事務及庫務局
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23 January 2015

Ms Angel Shek
Clerk to Panel on Financial Affairs
Legislative Council Complex
1 Legislative Council Road
Central
Hong Kong

Dear Ms Shek,

Legislative Council Panel on Financial Affairs

Follow-up actions arising from the meeting on 5 January 2015 Legislative Proposal to Extend Profits Tax Exemption for Offshore Funds to Private Equity Funds

Thank you for your letter of 7 January 2015. Our responses to the issues raised at the meeting on 5 January 2015 in relation to the legislative proposal to extend profits tax exemption for offshore funds to private equity funds are set out below:

- (a) To explain the policy consideration for imposing the proposed restrictive qualifying conditions set out in paragraph 11 of the Administration's paper (LC Paper No.CB(1)385/14-15(02)) on a portfolio company**
- (b) To consider relaxing the conditions in (a) above and/or waiving the conditions for certain types of portfolio company (e.g. high-technology and innovative companies), with a view to attracting these companies to use Hong Kong as a platform for corporate financing and asset management through private equity funds**

2. The proposed conditions that a portfolio company should meet to be qualified reflect our policy intent to extend the profits tax exemption for offshore funds to include transactions in private companies which do not hold any Hong Kong properties nor carry out any business in Hong Kong. Taking into account the common practices of private equity funds, we propose to provide certain flexibility so that the portfolio companies may carry on business activities of a purely preparatory or auxiliary character, and that they may hold immovable property the value of which should not exceed 10% of the value of the total assets of the private company. The proposal is formulated in consultation with the industry.

3. Any further relaxation of the conditions may create loopholes against tax avoidance as it would be made easier for companies to simply convert their taxable profits to non-taxable income via an offshore fund structure. Regarding the proposal to relax/waive the conditions for certain types of portfolio companies (e.g. high-technology and innovative companies), this would have wide-ranging read-across implications. We need to consider this carefully from the fairness perspective.

(c) On the proposed condition that an eligible portfolio company should not carry on any business through or from any permanent establishment in Hong Kong, to consider relaxing the requirement if the portfolio company's income derived from Hong Kong does not exceed a specified threshold (say 5% to 10%) of its total income.

4. As explained above, our policy intent of the proposal is to extend the profits tax exemption for offshore funds to include transactions in private companies which do not hold any Hong Kong properties nor carry out any business in Hong Kong. Allowing offshore private companies to carry on business through or from any permanent establishment in Hong Kong will result in giving profits tax exemption to all transactions in securities in private companies carrying on business in Hong Kong. This may give rise to tax drain issues. Nonetheless, understanding that offshore private companies may have some insignificant business activities in Hong Kong without giving rise to significant profits tax liability under the provisions of the Inland Revenue Ordinance, we propose to make clear in the law that if the place of business is for carrying on business activities of a purely preparatory or auxiliary character, such a place will not be considered as a permanent establishment. It would not be satisfactory if a de-minimus rule based

on income of the portfolio company is adopted since the income may fluctuate within the 3 years and at times losses are incurred instead of making any income.

Yours sincerely,

A handwritten signature in black ink, consisting of a long horizontal stroke followed by a stylized, looped flourish on the right side.

(Joyce Ho)
for Secretary for Financial Services
and the Treasury

c.c. Inland Revenue Department
(Attn: Mr Brian Chiu)
Hong Kong Monetary Authority
(Attn: Mr Enoch Fung)