

Bills Committee on Inland Revenue (Amendment) (No.4) Bill 2017

**Clause-by-clause Examination
Draft Committee Stage Amendments**

PURPOSE

This paper presents the Government's proposed amendments to the Inland Revenue (Amendment) (No. 4) Bill 2017 ("the Bill") to address (a) possible concerns of ring-fencing on certain tax features by the international community and (b) the tax treatment of investment by onshore privately offered open-ended fund companies (hereinafter referred to as "subject OFCs") in private companies.

BACKGROUND

2. As set out in the Legislative Council Brief on the Bill (File Ref: ASST/3/1/5/1C(2017)Pt.6) issued in June 2017, the investment scope of the subject OFCs should largely align with Type 9 (asset management) regulated activity ("permissible asset classes")¹, with a degree of flexibility by allowing a 10% de minimis limit (i.e. a maximum of 10% of the total gross asset value of the fund) for investing in "non-permissible asset classes". The definition of "securities" under the Securities and Futures Ordinance (Cap. 571, "SFO") does not include shares or debentures of private companies within the meaning of section 11 of the Companies Ordinance (Cap. 622). In other words, a subject OFC may invest in securities of overseas private companies without a limit, but can only invest in securities of local private companies up to 10% of the subject OFC's gross asset value at the fund regulation level.

3. The investment scope for privately offered OFCs and the 10% de minimis rule will be set out in the OFC Code to be issued by the Securities and Futures Commission ("SFC"). The Bill was formulated with the OFC Code and other applicable legal and regulatory requirements in mind.

¹ The permissible asset classes essentially consist of securities, futures and over-the-counter derivatives (when the relevant law comes into effect) as well as cash, bank deposits, certificates of deposit, foreign currencies and foreign exchange contracts.

4. At the Bills Committee meeting held on 20 July 2017, some Members enquired whether there was a technical loophole that might give rise to tax leakage. Specifically, since overseas private companies could in turn own assets in Hong Kong, there were concerns that this might give rise to a risk of tax evasion (e.g. trading assets chargeable to profits tax upon sale may become tax-exempted if the sale is structured through an OFC which sells shares in an overseas private company holding such trading assets).

5. At the same time, the international community is increasingly concerned about ring-fencing tax features. Jurisdictions with harmful tax features may be labelled as non-cooperative and subject to more stringent trade measures. In December 2017, the Council of the European Union announced a list of non-cooperative tax jurisdictions. While Hong Kong is not on the list, the Government has committed to removing all ring-fencing features from our current tax regimes for offshore funds. We have to ensure that any new tax incentives, including the current proposal for the subject OFCs and the tax treatment of their investment (i.e. local versus overseas private companies) will not have ring-fencing features.

PROPOSAL

6. To plug the technical tax evasion loophole and address the ring-fencing concern, we propose that amendments be made to the Bill so that a subject OFC, as long as it has been registered with the SFC² and meets other requirements in the Bill (e.g. the non-closely held condition), would be allowed to enjoy tax exemption on all of its profits provided that (a) it does not carry on any other trade or business in Hong Kong (see paragraph 7 below) and (b) it does not invest in certain specified types of private companies (see paragraph 9 below).

The 10% de minimis rule

7. As an OFC would already be required to comply with the 10% de minimis rule as per the OFC Code at the fund regulation level under

² A fund has to fulfil the requirements as stipulated under the Securities and Futures (Amendment) Ordinance 2016 as well as the subsidiary legislation and code made/issued by the SFC pursuant to the SFO to be able to seek for registration as an OFC. The SFC would issue a letter of registration to a fund which has successfully been registered as an OFC. There will also be a register of OFCs which can be inspected by the public.

the supervision of the SFC, we do not see a need to repeat this rule in the Bill. With the removal of this rule from the Bill, a subject OFC carrying out transactions in the permissible asset classes (see footnote 1 above) (“qualifying transactions”) will not be taxed on its profits arising from such transactions. If it carries out non-qualifying transactions, it will only be assessed to tax in respect of profits from direct trading or direct business undertaking in Hong Kong or utilisation of such assets with a view to generating income. The tax-exempt profits of the OFC will not be tainted.

8. If a subject OFC breaches the OFC Rules and/or Code (including the 10% de minimis rule) in a way that results in cancellation of registration by the SFC, it will not be eligible for profits tax exemption.

Investment in private companies

9. We propose to amend the Bill such that a subject OFC could enjoy profits tax exemption on its investment in private companies (whether local or overseas), provided that –

- (a) these investee private companies do not hold, directly or indirectly, more than 10% of their assets in local immovable property; and
- (b) if a subject OFC has a controlling interest in an investee private company, 50% or more of the private company’s assets (other than local immovable property) should be held for more than three years. Such a minimum holding period is set to reduce the risk of tax abuse by onshore entities engaging in speculative activities.

10. In sum, a subject OFC will only be taxed on its profits from: (a) direct trading or direct business undertaking in Hong Kong in relation to the non-qualifying transactions (as explained in paragraph 7 above); and (b) investment in private companies that cannot meet the requirements under paragraph 9 above. Also, there will be no tainting, i.e. the tax-exempt profits of the OFC will not be tainted even if profits tax has to be paid under (a) and/or (b) above.

ADVICE SOUGHT

11. Members are invited to examine the Government's proposed draft Committee Stage Amendments ("CSAs") at **Annex A**. A marked-up revision of the Bill is at **Annex B**. The proposed CSAs may be subject to revision.

Financial Services and the Treasury Bureau
Inland Revenue Department
6 February 2018

Inland Revenue (Amendment)(No.4) Bill 2017

Committee Stage

Amendments to be moved by the Secretary for Financial Services and the Treasury

<u>Clause</u>	<u>Amendment Proposed</u>
4	In the proposed section 20AG(4), by deleting “from a transaction referred to in section 20AH(1)(a) or (b)”.
4	<p>In the proposed section 20AH(1)—</p> <p>(a) in paragraph (a), by deleting “and”</p> <p>(b) in paragraph (b), by deleting the full stop and substituting “; and”.</p> <p>(c) by adding—</p> <p>“(c) transactions in assets of a non-Schedule 16A class if the activities that produce assessable profits from the transactions—</p> <p>(i) are carried out in Hong Kong by or through a qualified person; or</p> <p>(ii) are arranged in Hong Kong by a qualified person.”.</p>
4	<p>In the proposed section 20AH(2)—</p> <p>(a) in paragraph (a), by adding “and” after “;”</p> <p>(b) in paragraph (b), by deleting “; and” and substituting a full stop;</p> <p>(c) by deleting paragraph (c).</p>
4	<p>In the proposed section 20AH, by adding—</p> <p>“(4A) Despite subsection (1), if, during the basis period for a year of assessment—</p> <p>(a) an open-ended fund company carries on a trade, profession or business that involves transactions in shares of, or debentures issued by, a private company (<i>company concerned</i>); and</p>

- (b) the company concerned holds (whether directly or indirectly) immovable property in Hong Kong or share capital (however described) in one or more private companies with direct or indirect holding of immovable property in Hong Kong, and the aggregate value of the holding of the property (if any) and the share capital (if any) is equivalent to more than 10% of the value of the company concerned's assets,

the open-ended fund company is not exempt from the payment of tax chargeable under this Part in respect of its assessable profits for the period from the transactions.

- (4B) Despite subsection (1), if, during the basis period for a year of assessment—

- (a) an open-ended fund company carries on a trade, profession or business that involves transactions in shares of, or debentures issued by, a private company (other than a private company with a holding or shareholding referred to in subsection (4A)(b)) and has control over the private company;
- (b) the private company holds (whether directly or indirectly) short-term assets;
- (c) the aggregate value of the short-term assets is equivalent to more than 50% of the value of the assets of the private company; and
- (d) the open-ended fund company disposes of the shares or debentures through a transaction or a series of transactions,

the open-ended fund company is not exempt from the payment of tax chargeable under this Part in respect of its assessable profits for the period from the transactions.

- (4C) Despite subsection (1), if, during the basis period for a year of assessment, an open-ended fund company—

- (a) carries on direct trading or a direct business undertaking in Hong Kong in assets of a non-Schedule 16A class; or
- (b) holds assets of a non-Schedule 16A class and the assets are being utilized with a view to generating income,

the open-ended fund company is not exempt from the payment of tax chargeable under this Part in respect of its assessable profits for the period from the direct trading, business

undertaking or utilization of assets.”.

4 In the proposed section 20AH(9), by adding—

“**control** () has the meaning given by section 20AC(6);

private company () has the meaning given by section 20ACA(2);

short-term asset (), in relation to a private company the shares or debentures of which are being disposed of by an open-ended fund company, means an asset—

- (a) that is of a non-Schedule 16 class;
- (b) that is not immovable property in Hong Kong; and
- (c) that has been held by the private company for less than 3 consecutive years before the date of disposal.”.

4 In the proposed section 20AI(6), in paragraph (f) of the definition of **qualified investor**, by deleting “Authority.” and substituting “Authority;”.

4 In the proposed section 20AI(6), in the definition of **qualified investor**, by adding—

“(g) an investment arrangement, which is commonly known as a sovereign wealth fund, established and funded by a state or government (or any political subdivision or local authority of a state or government) for the purposes of—

(i) carrying out financial activities; and

(ii) holding and managing a pool of assets,

for the benefit of the state or government (or the political subdivision or local authority).”.

4 In the proposed section 20AJ, by deleting subsection (2).

4 In the proposed section 20AJ(4), by deleting the definition of **non-Schedule 16A class**.

4 In the proposed section 20AL, by deleting the heading and substituting—

“**20AL. Losses sustained by open-ended fund companies**”.

- 4 In the proposed section 20AL(1), by deleting “(a) or (b)” and substituting “(a), (b) or (c)”.
- 4 In the proposed section 20AL(2)—
- (a) by deleting “under section 20AH” and substituting “under section 20AH (other than because of subsection (4A), (4B) or (4C))”;
 - (b) by deleting “(a) or (b)” (wherever appearing) and substituting “(a), (b) or (c)”.
- 4 In the proposed section 20AL(3)—
- (a) by deleting “a non-Schedule 16A transaction” and substituting “a transaction, direct trading, direct business undertaking, or utilization of assets, in respect of which there is not an exemption from the payment of tax for assessable profits under section 20AH(4A), (4B) or (4C)”;
 - (b) by deleting “non-Schedule 16A transactions” and substituting “the transaction, direct trading, direct business undertaking or utilization of assets”.
- 4 In the proposed section 20AL, by deleting subsection (4).
- 6 In the proposed Schedule 16A, after item 1, by adding—
- “1A. Shares of, or debentures issued by, a private company within the meaning of section 11 of the Companies Ordinance (Cap. 622).”.

Inland Revenue (Amendment) (No.4) Bill 2017

Amendments to the Inland Revenue Ordinance (Cap. 112) (“IRO”)

Clause 4

In the proposed section 20AG¹:

“20AG. Sub-funds of open-ended fund companies

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- (4) Any loss sustained by a sub-fund ~~from a transaction referred to in section 20AH(1)(a) or (b)~~ is not available for set off against any assessable profits of another sub-fund of the same main company.
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- .”

¹ This proposed amendment is consequential to the proposed amendments to section 20AH (see footnote 2 below). Since the 10% de minimis rule will be removed from the Bill and an onshore privately offered open-ended fund company (hereafter referred to as “a subject OFC”) will be able to enjoy tax exemption on all of its transactions (save for the exceptions in the proposed section 20AH(4A), (4B) and (4C)), it should suffice to say that any loss, whether from tax-exempt or taxable transactions, sustained by a sub-fund cannot be used to set off the assessable profits of another sub-fund of the same OFC.

In the proposed section 20AH²:

“20AH. Certain profits of certain open-ended fund companies exempt from payment of tax

- (1) If, in respect of an open-ended fund company, all the conditions set out in subsection (2) are met, or regarded under this Part as having been met, at all times during the basis period for a year of assessment, the company is exempt from the payment of tax otherwise chargeable under this Part in respect of its assessable profits for the period from—
- (a) qualifying transactions within the meaning of subsection (3); ~~and~~
 - (b) subject to subsection (4), transactions incidental to the carrying out of qualifying transactions (*incidental transactions*); ~~and~~
 - (c) transactions in assets of a non-Schedule 16A class if the activities that produce assessable profits from the transactions—
 - (i) are carried out in Hong Kong by or through a qualified person; or
 - (ii) are arranged in Hong Kong by a qualified person.
- (2) The conditions are—
- (a) that the company is a resident person; ~~and~~
 - (b) that the company is non-closely held; ~~and~~
 - ~~(c) either—~~
 - ~~(i) the trade, profession or business carried on by the company in Hong Kong does not involve transactions in assets of a non-Schedule 16A class; or~~
 - ~~(ii) the trade, profession or business carried on by the company in Hong Kong involves transactions in assets of a non-Schedule 16A class but the percentage~~

² The amendments to section 20AH are proposed to (a) plug a technical loophole in the Bill to prevent tax leakage and (b) address the international community’s concern about ring-fencing. After the amendment, a subject OFC can enjoy tax exemption on all of its profits, provided that such profits do not arise from (i) direct trading or direct business undertaking in Hong Kong or utilisation of such assets with a view to generating income and (ii) investment in private companies that do not meet the prescribed requirements. The tax-exempt profits of the OFC will not be tainted.

~~calculated according to the following formula does not exceed 10%—~~

$$\frac{A}{B} \times 100\%$$

~~where—~~

~~A=value of all the company's assets of a non-Schedule 16A class;~~

~~B=value of all the company's assets.~~

- (3) For the purposes of this section, a transaction is a qualifying transaction if—
- (a) it is a transaction in assets of a class specified in Schedule 16A; and
 - (b) the activities that produce assessable profits from the transaction—
 - (i) are carried out in Hong Kong by or through a qualified person; or
 - (ii) are arranged in Hong Kong by a qualified person.
- (4) The company is not exempt under subsection (1) from the payment of tax in respect of its assessable profits for the basis period from incidental transactions if the percentage calculated according to the following formula exceeds 5%—

$$\frac{A}{B} \times 100\%$$

where—

A = the company's trading receipts from incidental transactions in the period;

B = the total of the company's trading receipts from qualifying transactions and incidental transactions in the period.

(4A) Despite subsection (1), if, during the basis period for a year of assessment—

(a) an open-ended fund company carries on a trade, profession or business that involves transactions in shares of, or debentures issued by, a private company (*company concerned*); and

(b) the company concerned holds (whether directly or indirectly) immovable property in Hong Kong or share capital (however described) in one or more private companies with direct or indirect holding of immovable property in Hong Kong, and the aggregate value of the

holding of the property (if any) and the share capital (if any) is equivalent to more than 10% of the value of the company concerned's assets,

the open-ended fund company is not exempt from the payment of tax chargeable under this Part in respect of its assessable profits for the period from the transactions.

(4B) Despite subsection (1), if, during the basis period for a year of assessment—

(a) an open-ended fund company carries on a trade, profession or business that involves transactions in shares of, or debentures issued by, a private company (other than a private company with a holding or shareholding referred to in subsection (4A)(b)) and has control over the private company;

(b) the private company holds (whether directly or indirectly) short-term assets;

(c) the aggregate value of the short-term assets is equivalent to more than 50% of the value of the assets of the private company; and

(d) the open-ended fund company disposes of the shares or debentures through a transaction or a series of transactions;

the open-ended fund company is not exempt from the payment of tax chargeable under this Part in respect of its assessable profits for the period from the transactions.

(4C) Despite subsection (1), if, during the basis period for a year of assessment, an open-ended fund company—

(a) carries on direct trading or direct business undertaking in Hong Kong in assets of a non-Schedule 16A class; or

(b) holds assets of a non-Schedule 16A class and such assets are being utilized with a view to generating income,

the open-ended fund company is not exempt from the payment of tax chargeable under this Part in respect of its assessable profits for the period from the direct trading, business undertaking or utilization of assets.

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(9) In this section—

control () has the meaning given by section 20AC(6);

non-Schedule 16A class (非附表 16A 類別) means a class that is not specified in Schedule 16A;

private company () has the meaning given by section 20ACA(2);

qualified person (合資格人士) means a corporation licensed under Part V of the Securities and Futures Ordinance (Cap. 571) to carry on, or an authorized financial institution registered under that Part for carrying on, a business in Type 9 regulated activity as referred to in Part 1 of Schedule 5 to that Ordinance;

short-term asset () in relation to a private company the shares or debentures of which is being disposed by an open-ended fund company, means an asset—

(a) that is of a non-Schedule 16A class;

(b) that is not immovable property in Hong Kong; and

(c) that has been held by the private company for less than 3 consecutive years before the date of disposal.

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In the proposed section 20AI³:

“20AI. Interpretation of section 20AH: meaning of non-closely held

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(6) In this section and Schedule 16B—
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³ As set out in our response to the industry’s submissions to the Bills Committee (LC Paper No. CB(1)415/17-18(01)), it is our policy intent for sovereign wealth funds (“SWFs”) to fall within the definition of “qualified investor”. However, it has come to our attention that the current definition may not be sufficient to cover SWFs (e.g. SWFs may not always be governmental entities and may fall outside the definition of “qualified investor”). The proposed amendment is to ensure that the definition can more clearly reflect our policy intent.

qualified investor (合資格投資者), in relation to an open-ended fund company, means any of the following—

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- (e) a governmental entity;
- (f) a fund established by a governmental entity, international organization, central bank or the Hong Kong Monetary Authority to provide retirement, disability or death benefits to beneficiaries or participants who—
 - (i) are current or former employees (or persons designated by such employees); or
 - (ii) are not current or former employees, if the benefits provided to such beneficiaries or participants are in consideration for personal services rendered for the governmental entity, international organization, central bank or the Hong Kong Monetary Authority;

(g) an investment arrangement, which is commonly known as a sovereign wealth fund, established and funded by a state or government (or any political subdivision or local authority of a state or government) for the purposes of—

(i) carrying out financial activities; and

(ii) holding and managing a pool of assets,

for the benefit of the state or government (or the political subdivision or local authority).”

In the proposed section 20AJ⁴:

“20AJ. Supplementary provisions for section 20AH

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~~(2) If an open-ended fund company carries on a trade, profession or business in Hong Kong involving transactions in assets of a non-Schedule 16A class and the condition set out in section~~

⁴ This amendment is consequential to the proposed changes to section 20AH (see footnote 2 above). Since the 10% de minimis rule will be removed from the Bill, the corresponding safe harbour would no longer be required.

~~20AH(2)(c)(ii) is not met (*failure*), the Commissioner may, on application by the company, nevertheless regard the condition as having been met in respect of the company if the Commissioner is satisfied that the failure is temporary and due to circumstances not reasonably foreseeable by the company, including—~~

- ~~(a) fluctuations in the value of the company's assets; and~~
- ~~(b) redemptions by investors beyond the company's control.~~

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(4) In this section—

~~*non-Schedule 16A class* (非附表 16A 類別) means a class that is not specified in Schedule 16A;~~

services (服務), in relation to an open-ended fund company, includes—

- (a) seeking funds for the company from participants or potential participants;
- (b) researching potential investments to be made for the company;
- (c) acquiring, holding, managing or disposing of property for the company; and
- (d) acting for the company with a view to assisting an entity in which the company has made an investment to raise funds.”

In the proposed section 20AL⁵:

“20AL. Losses sustained by open-ended fund companies~~Losses from section 20AH(1) transactions and non-Schedule 16A transactions~~

- (1) If an open-ended fund company is exempt from the payment of tax under section 20AH in respect of its assessable profits in a

⁵ These amendments are consequential to the proposed changes to section 20AH (see footnote 2 above) to keep in line with the general tax principle that losses from tax-exempt transactions can only be used for set off against assessable profits from tax-exempt transactions, and that losses from taxable transactions can only be used for set off against assessable profits from taxable transactions.

year of assessment, any loss sustained by the company from a transaction referred to in section 20AH(1)(a), ~~or~~ (b) or (c) in the year of assessment is not available for set off against any assessable profits of the company in the year of assessment or any subsequent year of assessment.

(2) If an open-ended fund company is not exempt from the payment of tax under section 20AH (other than because of subsection (4A), (4B) or (4C)) in respect of its assessable profits in a year of assessment, any loss sustained by the company from a transaction referred to in section 20AH(1)(a), ~~or~~ (b) or (c) in the year of assessment is only available for set off against any assessable profits of the company from transactions referred to in section 20AH(1)(a), ~~or~~ (b) or (c) in the year of assessment or any subsequent year of assessment.

(3) Any loss sustained by an open-ended fund company from a transaction, direct trading, or direct business undertaking, or utilization of assets, in respect of which there is not an exemption from the payment of tax for assessable profits under section 20AH(4A), (4B) or (4C) ~~a non-Schedule 16A transaction~~ in a year of assessment is only available for set off against any assessable profits of the company from the transaction, direct trading, direct business undertaking or utilization of assets ~~non-Schedule 16A transactions~~ in the year of assessment or any subsequent year of assessment.

~~(4) In this section —~~

~~**non-Schedule 16A class** (非附表 16A 類別) means a class that is not specified in Schedule 16A;~~

~~**non-Schedule 16A transaction** (非附表 16A 交易) means a transaction in assets of a non-Schedule 16A class.”~~

Clause 6

In the proposed Schedule 16A⁶:

“Schedule 16A

[ss. 20AB, 20AH, 20AJ &
20AL]

Classes of Assets Specified for Purposes of Section 20AH

1. Securities as defined in Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571).
- 1A. Shares of, or debentures issued by, a private company within the meaning of section 11 of the Companies Ordinance (Cap. 622).
2. Futures contracts as defined in Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571).
3. Foreign exchange contract under which the parties to the contract agree to exchange different currencies on a particular date.
4. Deposits (as defined in section 2(1) of the Banking Ordinance (Cap. 155)) made with a bank (as defined in Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571)).
5. Foreign currencies.
6. Certificates of deposit as defined in Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571).
7. Cash.
8. OTC derivative products as defined in Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571).”

⁶ The proposed amendment is to remove the ring-fencing feature in the Bill such that investment in both local and overseas private companies will be considered qualifying transactions.