LC Paper No. CB(1)150/05-06(01)(Revised)

Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005
Response to the Deputations by the Administration

Mr Chairman,

Thank you for the various deputations' views on the Exemption Bill. Detailed responses to the deputations have been made in writing and tabled before members. For the oral responses and in the time allowed, I (Mrs Lau Mak Yee Ming, Alice, Commissioner of Inland Revenue) will address the major issues raised by the various parties.

I would say the Bill is generally supported by the majority of the deputations, albeit with calls for minor adjustments to achieve the policy objective of the Bill. Of course there are calls that are at odds with the policy objective, such as the exemption for onshore funds, and these cannot be taken on board. In deliberating whether adjustments are justified, those consistent with the objective and facilitating the achieving of the objective will be considered.

Policy Objective of the Bill

As clearly shown by the title of the Bill, "Profits Tax Exemption for Offshore Funds", the objective is to exempt Offshore Funds from tax in respect of trading profits derived from qualifying securities transactions carried out in Hong Kong through specified persons. Although the exemption is not intended for onshore funds, it is conceivable that this exemption will bring in increased activities in the securities field and will thus benefit down-stream services sectors, such as the funds management sector, the legal sector, the accountancy sector and the financial services sector.

The exemption is intended to boost the competitiveness of Hong Kong as a financial centre, and the scope of exemption is in line with that offered by other major financial centres, such as the United States, United Kingdom and Singapore. On the other hand, we are not aware that any major centre offers exemption to its onshore funds.

Residence

As the exemption is only intended for offshore funds, it is necessary to have a test on the identity of those offshore funds.

For this purpose, the international practice is to adopt a "residence" test, such that only funds that are non-resident qualify for the exemption. The Administration has conducted two rounds of consultation on how to exempt offshore funds. In the 1st round, we suggested the Singapore model be adopted, namely, offshore funds managed by fund managers and, at the investor level, with no more than 20% beneficial interest owned by residents qualify for exemption. However, the industry declined such a suggestion as that would entail the tracing of beneficiary interests and they expressed they simply could not comply with the requirement.

We then continued to consult the industry by way of a second round and have come up with the present proposed tests on residence, namely, a number of "specified days" for individuals and the "central management and control" criterion for corporations and other non-individual entities at the entity level (rather than at the investor level as earlier suggested and rejected).

The "central management and control" test is a well-established common law principle, which is widely adopted by many jurisdictions in determining residency for non-individual entities for their domestic tax purposes. The test we adopt refers to the highest level of control and management (as established by case law), not the day-to-day operation of the business. The feedback from the industry on this test is generally favourable. Examples on how this residence test is applied have been set out clearly in the Supplementary Notes, and will be included in a Departmental Interpretation and Practice Notes [“DIPN”] on this topic when the bill is enacted. We know of no jurisdiction that adopts the central management and control test stipulating a statutory definition in its law.

As a test has to be required to determine residency for exemption purposes, the test now recommended is a workable solution and in line with the international practice. We cannot think of any alternative for the present purpose.

Further, an onshore fund remains exempt from profits tax in respect of trading profits made offshore, as is the existing position. The “exemption provision” under section 20AC will not render an onshore fund liable to tax in respect of profits made by it offshore. Section 20AC only exempts profits which are otherwise chargeable to tax. It is not a charging section and does not affect the existing territorial basis of taxation and also does not make capital gains (which are exempt under existing law) taxable. We shall be happy to clarify the position in a DIPN.

Deeming Provisions

As pointed out earlier, the exemption is intended for offshore funds, which remain subject to the existing law in respect of trading profits from securities transactions. To prevent residents from getting benefit from the exemption by way of round-tripping, it is necessary to have specific anti-avoidance provision to deny such benefit to them. To achieve this end, the deeming provisions will apply to a resident who owns beneficial interest in an exempt offshore fund by more then 30% (either singly or jointly with associates), or any holding where the offshore fund is his associate. The assessable profits of the offshore fund proportionate to his beneficial interest will be deemed to be his profits and assessed as such in his name.

The 30% as suggested in the Bill is a reasonable balance between prevention of avoidance and facilitating the resident investor to obtain information from the offshore fund to comply with the new law. Under the existing law, any person liable to tax has an obligation to report his liability to the Commissioner within 4 months after the end of the basis period of the relevant year of assessment.

Retrospective Exemption Provision

The retrospective exemption provision is much called for by the industry, so as to provide certainty for past years' assessments. The Administration acknowledges such a need.

As a matter of fact, the Administration intended in 1996 to implement the policy of providing tax exemption to ALL non-residents in respect of securities trading profits. However, the amendment did not succeed due to some unresolved technicality, and as a compromise, a narrower scope of exemption (i.e. only bona fide widely held funds regulated overseas were exempt under section 26A(1A) of the IRO) was adopted. The current objective of the Bill is to put through the 1996 intended offshore fund exemption regime, which is now much clamoured for by the industry and needed by Hong Kong to reinforce its status as an international financial centre.

I wish to make clear that the retrospective effect applies to the "exemption provision", with effect to the year of assessment 1996/97 onwards. The "deeming provision", however, takes effect from the date of enacting of the Bill. Hence no retrospectivity for the Deeming Provisions.

Scope of Qualifying Transactions

Some deputations call for expanding the scope of qualifying transactions to cover all transactions that are normally carried out by a fund, including the transaction of private company shares.

The present scope of qualifying transactions as proposed in the Bill covers “dealing in securities”, “dealing in futures contracts” and “leveraged foreign exchange trading” within the meaning of the Securities and Futures Ordinance. The Administration will examine the present scope to see if it needs to be expanded, and if so, a CSA will be proposed. However, there is a limit to such expansion, and private company shares are considered not suitable for inclusion, as a person may trade in any type of assets (such as landed properties) through transfer of shares in private companies. Inclusion of private company shares would run the risk of granting exemption to all sorts of trading transactions.

Committee Stage Amendments (CSA)

Apart from the expanding of the scope of qualifying transactions, the Administration will also examine whether the list of specified persons through whom the qualifying transactions are conducted will also be expanded. Moreover, non-participating management shares held by fund managers will also be carved out from the application of the deeming provisions. The relevant CSAs will be worked out for the Bills Committee’s consideration at a later stage.

Conclusion

Mr Chairman and members of the Bills Committee, you have heard the deputations. It is fair to say that the majority favours the Bill. There are deputations calling for the exemption for funds centrally managed and controlled in Hong Kong. But I have to say there is a limit to the exemption, which is intended for offshore funds only. Such onshore funds are no different from other companies centrally managed and controlled in Hong Kong, and should be so treated as those onshore companies. No new tax liability is created for these onshore companies, which, as before, remain to be chargeable to tax in respect of trading profits from securities transactions carried out in Hong Kong.

Thank you.