

Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005

Purpose

This paper sets out the draft Committee Stage Amendments (“CSAs”) (at *Annex*) that the Administration plans to introduce to the Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005, having regard to views on the Bill expressed by deputations and Members.

Scope of exemption

2. Deputations expressed the view that the scope of exemption might not be wide enough to cover the typical transactions carried out by offshore funds, and suggested that the definition of “securities” should be expanded for the purposes of the exemption to cover certain financial products commonly traded by offshore funds. The Administration has carefully reviewed the definition of “securities” and would like to make certain adjustments to the Bill.

3. It is proposed that exempt transactions should refer to those “specified transactions” of an offshore fund carried out through or arranged by a corporation licensed or an authorised financial institution registered under the Securities and Futures Ordinance (Cap. 571) (“SFO”). “Specified transactions” would be listed out in a new schedule to be added to the Inland Revenue Ordinance (Cap. 112) (“IRO”). Provisions would be added to empower the Commissioner of Inland Revenue to amend the list of “specified transactions” to cater for changes in the financial products traded in the market. The list contains six “specified transactions” as follows -

- (a) Transactions in securities,
- (b) Transactions in futures contracts,

- (c) Transactions in foreign exchange contracts;
- (d) Transactions in foreign currencies;
- (e) Transactions in exchange-traded commodities; and
- (f) Making of deposits other than by way of a money-lending business.

The term “transactions” will include both exchange-traded transactions and over-the-counter transactions.

Securities

4. For the purpose of the Bill, exemption will be allowed by reference to the nature of a financial product rather than its product name. In the proposed Schedule, “securities” will be widely defined by the generic wordings to mean the following -

- (a) shares, stocks, debentures, loan stocks, funds, bonds or notes;
- (b) rights, options or interests in, or in respect of, such shares, stocks, debentures, loan stocks, funds, bonds or notes;
- (c) certificates of interest in or participating in, receipts for, or warrants to subscribe for or purchase such shares, stocks, debentures, loan stocks, funds, bonds or notes;
- (d) interests in any collective investment scheme; or
- (e) interests, rights or property commonly known as securities.

5. The definition in item (b) would cover index options as these are options “in respect of” shares and stocks, as well as derivatives on securities (whether cash settled or otherwise). Item (e) would have particular application to other options, derivatives and swaps that are not in relation to financial products referred to under item (a), since these fall squarely within the meaning of

“interest, right or property”, so long as they are commonly known as securities. Examples covered are commodity options, derivatives related to commodities, interest rate options, interest rate swaps, forex options, currency swaps, and derivatives on foreign exchange. Certificates of deposit (if not already covered under item (a)), bills of exchange and promissory notes would also be covered under item (e).

6. In item (d) above, the term “collective investment scheme” (“CIS”) would be defined in a manner more or less similar to that under Paragraph 1, Part 1 of Schedule 1 to the SFO. Furthermore, as the property under management by a CIS would itself include a fund, a CIS would include a fund-of-funds.

7. The Administration, however, has to reiterate that exemption would not be allowed in respect of shares or debentures of a private company as the inclusion of such shares or debentures would unintentionally widen the scope of exemption. It is envisaged that a person in effect can trade in any types of assets through transfer of shares in private companies purposely set up for holding such assets.

8. It should also be made clear that, whilst the term “securities” is also defined in the SFO, the interpretation and practice of “securities” under the IRO is not related to, and should not affect the administration of, the SFO.

Futures contracts

9. The term "futures contract" would be defined to cover -

- (a) a contract or an option on a contract which is listed or traded on the Hong Kong Futures Exchange Ltd; and
- (b) any other contract for differences which is listed on any specified stock exchange, or traded on any specified futures exchange,

within the meaning of the SFO, or which is entered into by an authorized institution under the Banking Ordinance (Cap. 155), or which is regulated by or under, or which is carried out in compliance with the SFO.

The lists of “specified futures exchanges” and of “specified stock exchanges” can be found in Parts 2 and 3 respectively of Schedule 1 to the SFO.

Foreign currency transactions

10. The Administration agrees with deputations’ views that “leveraged foreign exchange trading” in the Bill should be expanded to cover spot as well as non-leveraged foreign exchange transactions carried out by offshore funds. Accordingly, transactions in foreign currencies at a future time (to be defined as “foreign exchange contracts”) would be covered by item (c) in the Schedule of “specified transactions”, whereas those in spot foreign currencies would be covered by item (d) in the Schedule. Members may wish to note that both leveraged and non-leveraged transactions, as well as listed and non-listed contracts, are covered.

Exchange Traded Commodities

11. Depending on the investment strategies of the fund managers, a fund may trade in commodities that are listed on the various exchanges. These may cover gold, silver, oil, coffee beans, etc. The Administration agrees to include transactions in exchange-traded commodities¹ within the scope of “specified transactions”.

Making of deposits

12. The Administration agrees with deputations’ views that offshore funds in

¹ The definition of “exchange-traded commodities” will be provided later.

the normal course of business may hold money deposits in their asset portfolios. “Making of deposits other than by way of a money-lending business” is now added as a specified transaction which is to be covered by the exemption. The deposits may be in any currency.

13. The term “money-lending business” would be given its ordinary meaning. It is a question of fact whether a money-lending business is carried on. Whether there is a money-lender’s licence is not conclusive in the context of the IRO (see *Shu Lee Investment Ltd.*,¹ HKTC 322, and Board of Review Case No. D38/89, 4 Vol. 433).

Non-profit participating shares

14. Some deputations pointed out that a fund manager of a non-resident fund corporation may hold non-profit participating shares for the sole purpose of managing the fund corporation. The Administration considers that there is a genuine need for a fund manager to hold non-profit participating shares and agrees that this type of share (whether held by a fund manager or any other person) which does not entitle the holder to distribution of profits and distribution of assets upon dissolution (other than a return of capital), should not be taken into account in ascertaining a resident person’s beneficial interest in a non-resident fund corporation. To be consistent and to avoid possible abuse, such type of share should be excluded from the total issued share capital of the corporation concerned for the purpose of calculating a resident holder’s threshold of direct and/or indirect beneficial interest in the corporation.

Specified person

15. The Bill proposes that profits tax exemption would be allowed in respect of qualified transactions (to be renamed “specified transactions”) provided that the transactions are carried out through a “specified person”. Under the Bill, a “specified person” is a person who holds a Type 1 [dealing in securities], Type 2

[dealing in futures contracts], Type 3 [leveraged foreign exchange trading] or, to a certain extent, Type 9 [asset management] licence under the SFO. Some deputations pointed out that the definition of “specified person” should be relaxed to cover holders of all types of licences under the SFO. The Administration agrees with the deputations’ proposal. The CSAs would define “specified person” to mean “a corporation licensed under Part V of the SFO to carry on, or an authorized financial institution registered under that Part for carrying on, a business in any regulated activity within the meaning of Schedule 5 to that Ordinance”. The amendment will also make it clear that a “specified transaction” qualifies for exemption so long as it is “carried out through or arranged by” a specified person. The inclusion of the words “arranged by” would cover cases where, for example, a specified person arranges to buy some overseas stocks.

Meaning of “specified person” before enactment of the SFO in 2003

16. The Bill proposes that the Exemption Provisions are to apply retrospectively to any year of assessment commencing on or after 1 April 1996. The Exemption Provisions would allow tax exemption in respect of qualified transactions carried out through a “specified person” who is a licence holder under the SFO. As the SFO only came into operation on 1 April 2003, a separate definition is required for “specified person” in respect of the period prior to 1 April 2003. Before the enactment of the SFO, a “specified person” licensed to carry out securities transactions should be a dealer, an investment adviser, a commodity trading adviser, a securities margin financier or a leveraged foreign exchange trader registered or licensed under the repealed Securities Ordinance (Cap. 333), the repealed Commodities Trading Ordinance (Cap. 250) or the repealed Leveraged Foreign Exchange Trading Ordinance (Cap. 451), or a licensed bank under the BO. The Administration considers that these registered or licensed persons under the old law should be accepted as “specified person” in applying the Exemption Provisions in respect of the

period prior to 1 April 2003.

Effective date for the Deeming Provisions

17. The Bill proposes that the Deeming Provisions would apply at any time in the year of assessment in which the Bill is enacted or any subsequent year of assessment. As sufficient time should be given to the industry to devise effective and efficient monitoring mechanism to facilitate their supply of information to resident investors who are subject to the Deeming Provisions, the Administration considers that it would be reasonable and more effective to apply the Deeming Provisions with effect from the year of assessment immediately following the year of assessment in which the Bill is enacted. For example, if the Bill is enacted on 1 February 2006, the Deeming Provisions will become effective as from 1 April 2006. This commencement date would also mean that no person would be required to declare any deemed profits in his coming tax return for the year of assessment 2005-06.

Application of the Deeming Provisions by reference to the holding of both direct and indirect beneficial interests

18. The policy intent is to invoke the Deeming Provisions on a resident person by reference to his direct and indirect beneficial interests in an offshore fund taken as a whole. Some deputations pointed out that the existing wording of the Deeming Provisions in the proposed section 20AE(1) and (3) may not achieve the intended result when applying the triggering threshold and ascertaining the amount of deemed profits. For example, it is not patently clear whether a resident person who holds 20% direct and 20% indirect beneficial interests in an offshore fund will be caught by the Deeming Provisions. The Administration will propose some minor adjustments to the wording of the Deeming Provisions to put beyond doubt the policy intent of aggregating a resident person's direct and indirect beneficial interests in an offshore fund in applying the Deeming Provisions.

Treasury Branch,
Financial Services and the Treasury Bureau
November 2005

REVENUE (PROFITS TAX EXEMPTION FOR OFFSHORE FUNDS) BILL 2005

COMMITTEE STAGE

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

<u>Clause</u>	<u>Amendment Proposed</u>
2	<p>In the proposed section 20AB(4)(c), in the English text, by deleting subparagraph (ii) and substituting –</p> <p>“(ii) not being a trustee of the trust estate or, where the trustee is a corporation, a director of the trustee, is able or might reasonably be expected to be able to control the activities of the trust estate or the application of its corpus or income, otherwise than through another person.”.</p>
2	<p>In the proposed section 20AB, by adding –</p> <p>“(9) A reference to the issued share capital of a corporation does not include a reference to the shares comprised in the issued share capital that do not entitle their holders to receive dividends, whether in cash or in</p>

kind, and a distribution of the corporation's assets upon its dissolution other than a return of capital.”.

2 In the proposed section 20AC, by deleting subsections (1), (2), (3) and (4) and substituting –

“(1) Subject to subsections (5) and (6), a non-resident person is exempt from tax chargeable under this Part in respect of his assessable profits, for any year of assessment commencing on or after 1 April 1996, from –

- (a) transactions falling within subsection (2); and
- (b) transactions incidental to the carrying out of the transactions referred to in paragraph (a).

(2) A transaction falls within this subsection if it –

- (a) is a transaction specified in Schedule 16; and
- (b) has been carried out through or arranged by a specified person.”.

2

In the proposed section 20AC, by adding –

“(7) The Commissioner may by notice published in the Gazette amend Schedule 16.

(8) In subsection (2), a “specified person” (指明人士) means –

- (a) in relation to a transaction carried out before 1 April 2003 –
 - (i) a bank within the meaning of section 2(1) of the Banking Ordinance (Cap. 155);
 - (ii) a person registered as a dealer or commodity trading adviser under Part IV of the Commodities Trading Ordinance (Cap. 250) repealed under section 406 of the Securities and Futures Ordinance (Cap. 571);
 - (iii) a person registered as a dealer or an investment adviser under Part VI, or as a securities margin financier under Part XA, of the

Securities Ordinance (Cap. 333) repealed under section 406 of the Securities and Futures Ordinance (Cap. 571); or

(iv) a person licensed as a leveraged foreign exchange trader under Part IV of the Leveraged Foreign Exchange Trading Ordinance (Cap. 451) repealed under section 406 of the Securities and Futures Ordinance (Cap. 571); or

(b) in relation to a transaction carried out on or after 1 April 2003, 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 any regulated activity within the

meaning of Schedule 5 to that Ordinance.”.

2 In the proposed section 20AD, by adding “for any subsequent year of assessment” before the full stop.

2 In the proposed section 20AE, by deleting subsection (1) and substituting –

“(1) Where, in the year of assessment following the year of assessment in which the Revenue (Profits Tax Exemption for Offshore Funds) Ordinance 2005 (of 2005) commences or in any subsequent year of assessment –

(a) a resident person has, during any period of time, a beneficial interest, whether direct or indirect or both, in a non-resident person to the extent set out in subsection (2); and

(b) the non-resident person is exempt from tax under section 20AC,

the assessable profits of the non-resident person for that period of time that would have been chargeable to tax under this Part but for that section are to be regarded as

the assessable profits arising in or derived from Hong Kong of the resident person for that year of assessment from a trade, profession or business carried on by the resident person in Hong Kong.”.

2 In the proposed section 20AE, by deleting subsection (3) and substituting –

“(3) Where, in the year of assessment following the year of assessment in which the Revenue (Profits Tax Exemption for Offshore Funds) Ordinance 2005 (of 2005) commences or in any subsequent year of assessment –

(a) a resident person has, during any period of time, a beneficial interest, whether direct or indirect or both, in a non-resident person who is exempt from tax under section 20AC; and

(b) the non-resident person is an associate of the resident person,

the assessable profits of the non-resident person for that period of time that would have been chargeable to tax under this Part but for that section are to be regarded as

the assessable profits arising in or derived from Hong Kong of the resident person for that year of assessment from a trade, profession or business carried on by the resident person in Hong Kong.”.

2 In the proposed section 20AE, by deleting subsection (11).

New By adding –

“5. Schedule 16 added

The following is added –

“SCHEDULE 16 [s.20AC]

SPECIFIED TRANSACTIONS

1. a transaction in securities.
2. a transaction in futures contracts.
3. a transaction in foreign exchange contracts.
4. a transaction consisting in the making of a deposit other than by way of a money-lending business.
5. a transaction in foreign currencies.
6. a transaction in exchange-traded commodities.

In this Schedule –

“collective investment scheme” (集體投資計劃) means

arrangements in respect of any property –

- (a) under which the participating persons do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions in respect of the management;
- (b) under which –
 - (i) the property is managed as a whole by or on behalf of the person operating the arrangements;
 - (ii) the contributions of the participating persons and the profits or income from which payments are made to them are pooled; or
 - (iii) the property is managed as a whole by or on behalf of the person operating the arrangements, and the contributions of the participating persons and the profits or income from which payments are made to them are pooled; and
- (c) the purpose or effect, or pretended purpose or effect, of which is to enable the

participating persons, whether by acquiring any right, interest, title or benefit in the property or any part of the property or otherwise, to participate in or receive-

- (i) profits, income or other returns represented to arise or to be likely to arise from the acquisition, holding, management or disposal of the property or any part of the property, or sums represented to be paid or to be likely to be paid out of any such profits, income or other returns; or
- (ii) a payment or other returns arising from the acquisition, holding or disposal of, the exercise of any right in, the redemption of, or the expiry of, any right, interest, title or benefit in the property or any part of the property;

“contract for differences” (差價合約) means an agreement the purpose or effect of which is to obtain a profit or avoid a loss by reference to

fluctuations in the value or price of property of any description or in an index or other factor designated for that purpose in the agreement;

“debenture” (債權證) includes debenture stocks, bonds, and other securities of a corporation, whether constituting a charge on the assets of the corporation or not;

“deposit” (存款) means a loan of money –

- (a) at interest; or
- (b) repayable at a premium or repayable with any consideration in money or money’s worth;

“foreign exchange contract” (外匯交易合約) means a contract other than a futures contract and an options contract, whereby the parties to the contract agree to exchange different currencies at a future time;

“futures contract” (期貨合約) means –

- (a) a contract or an option on a contract that is listed or traded on the Hong Kong Futures Exchange Limited; or
- (b) any other contract for differences –
 - (i) that is listed on a specified stock exchange, or traded on a specified futures exchange, within the meaning of section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571);
 - (ii) that an authorized institution within the meaning of the Banking Ordinance (Cap. 155) may enter into under that Ordinance; or
 - (iii) the transaction in respect of which is regulated by or under, or is carried out in compliance with, the Securities and Futures Ordinance (Cap. 571);

“options contract” (期權合約) means a contract that gives the holder of the contract the option or right, exercisable at or before a time specified in the

contract to –

- (a) buy or sell –
 - (i) at an agreed consideration an agreed quantity of a specified futures contract, share or other property; or
 - (ii) an agreed value of a specified futures contract, share or other property; or
- (b) be paid an amount of money calculated by reference to the value of such futures contract, share or other property or by reference to the level of an index, as may be specified in the contract;

“property” (財產) includes –

- (a) money, goods, choses in action and land, whether in Hong Kong or elsewhere; and
- (b) obligations, easements and every description of estate, interest and profit, present or future, vested or contingent, arising out of or incident to property as defined in paragraph (a);

“securities” (證券) means –

- (a) shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a body, whether incorporated or unincorporated, or a government or municipal government authority;
- (b) rights, options or interests (whether described as units or otherwise) in, or in respect of, such shares, stocks, debentures, loan stocks, funds, bonds or notes;
- (c) certificates of interest or participation in, temporary or interim certificates for, receipts for, or warrants to subscribe for or purchase, such shares, stocks, debentures, loan stocks, funds, bonds or notes;
- (d) interests in any collective investment scheme;
- (e) interests, rights or property, whether in the form of an instrument or otherwise, commonly known as securities,

but does not include shares or debentures of, or rights, options or interests (whether described as units or otherwise) in, or in respect of, shares or debentures of, a

company that is a private company within the meaning of section 29 of the Companies Ordinance (Cap. 32);

“share” (股份) means any share in the share capital of a corporation, and, except where a distinction between stock and shares is express or implied, includes stock.”.”.