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Report of the Bills Committee on
Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005

Purpose

This paper reports on the deliberations of the Bills Committee on Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005.

Background

2. Under the existing Inland Revenue Ordinance (IRO) (Cap. 112), any person (both resident and non-resident) deriving trading profits from securities transactions carried out in Hong Kong are liable to pay profits tax. However, other major international financial centres (IFCs) including New York and London as well as the other major player in the region, Singapore, all exempt offshore funds from taxation. The fund industry has expressed the view to the Administration that due to keen international competition, it is vital for Hong Kong to provide profits tax exemption to offshore funds as with other major IFCs.

3. In order to reinforce the status of Hong Kong as an IFC and enhance Hong Kong's competitiveness vis-à-vis other IFCs, the Government proposed in the 2003-04 Budget to exempt offshore funds from profits tax. According to the Administration, the proposal would help to attract new offshore funds to Hong Kong and encourage existing offshore funds to continue to invest in Hong Kong. The Administration then conducted two rounds of consultation with the fund industry, interested parties and the public in early 2004 and early 2005 respectively on the approach for effecting the proposal of providing profits tax exemption for offshore funds. Respondents from the industry generally considered that the Administration's current approach was the correct one.

4. To give effect to the proposal, the Administration introduced the Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005 (the Bill) into the Legislative Council (LegCo) on 6 July 2005.

The Bill

5. The Bill seeks to amend the IRO to give effect to the proposal of providing profits tax exemption for offshore funds and to make related amendments. The Bill contains the following two main sets of provisions –

(a) Exemption provisions
These provisions exempt non-resident persons (including individuals, partnerships, trustees of trust estates, and corporations) from tax for profits derived from specified transactions carried out in Hong Kong, including dealing in securities, dealing in futures contracts and leveraged foreign exchange trading as defined in the Securities and Futures Ordinance (SFO) (Cap. 571). To qualify for the exemption, the transactions must be carried out by specified persons, which include corporations and authorized financial institutions licensed or registered under the SFO to carry out such transactions. The offshore funds must not carry on any other business (except transactions incidental to the specified transactions) in Hong Kong. It is proposed that the exemption provisions will apply with retrospective effect from the year of assessment commencing on 1 April 1996; and

(b) Deeming provisions
These are specific anti-avoidance provisions to prevent abuse or round-tripping by local funds disguised as offshore funds seeking to take advantage of the exemption. A resident person (including individuals, partnerships, trustees of trust estates or corporations), alone or jointly with his associates, directly or indirectly holding 30% or more of beneficial interest in a tax-exempt offshore fund, or has a direct or indirect beneficial interest of any percentage in a tax-exempt offshore fund which is the resident person's associate, will be deemed to have derived assessable profits in respect of profits earned by such offshore fund from specified transactions and incidental transactions in Hong Kong. The amount of the deemed assessable profits would be computed by taking into account the percentage of the resident's beneficial interest and the length of ownership within the relevant year of assessment, irrespective of whether the profits have been distributed to the resident. The deeming provisions will not apply if the Commissioner of Inland Revenue (C of IR) is satisfied that the offshore fund is bona fide widely held.

6. In summary, under the proposal non-residents deriving profits from securities transactions in Hong Kong are exempt from profits tax. A local resident who invests in bone fide widely held offshore funds or who, alone or jointly with his associates, holds a beneficial interest lower than 30% in an offshore fund (where the offshore fund is not his associate) is also exempt from profits tax.

The Bills Committee

7. The House Committee agreed at its meeting on 8 July 2005 to form a Bills Committee to study the Bill. The Bills Committee first met on 15 July 2005 and Hon James TIEN Pei-chun was elected Chairman. The membership list of the Bills Committee is in **Appendix I**.

8. The Bills Committee held a total of three meetings. It received a total of 35 submissions from 23 organizations/individuals and met with 16 of them. The list of the organizations/individuals concerned is in **Appendix II**.

Deliberations of the Bills Committee

9. The Bills Committee supports in principle the Administration's proposal to exempt offshore funds from profits tax as a means to enhance Hong Kong's competitiveness and anchor offshore funds in Hong Kong markets to maintain international expertise, promote new products, and further develop the local fund management industry. The Bills Committee notes that the fund industry and taxation professional bodies have expressed strong support for the Bill for the benefits of providing legal certainty of profits tax exemption for offshore funds, promoting and retaining the fund management industry in Hong Kong, and reinforcing the status of Hong Kong as an IFC and asset management centre. Some of the organizations/individuals however consider that the proposal may make offshore funds more attractive to investors, hence putting onshore funds in a less favourable position. Even for some of those who are in support of the proposal, there are also questions on the practicability of some of the exemption and deeming provisions. Some members of the Bills Committee also raise concern about the proposal to apply the exemption provisions with retrospective effect. In this connection, the Bills Committee has examined the Bill and the relevant concerns in detail.

Exemption provisions

Proposed residency tests for granting tax exemption
(Proposed section 20AB of the IRO)

10. In order to qualify for the proposed exemption from profits tax, a fund has to be a non-resident entity. In determining the residence of the fund, the Bill adopts two proposed criteria, as follows:

(a) Ordinary residency and number of "specified days" criteria for individuals

In respect of an individual, he/she will be regarded as a "non-resident" if (i) he/she does not ordinarily resides in Hong Kong, and (ii) he/she stays in Hong Kong for 180 days or less during the relevant year of assessment and 300 days or less in two consecutive years of assessment, one of which is the relevant year of assessment; and

(b) "Central management and control" criterion for non-individual entities
In respect of non-individual entities (including corporations, partnerships and trustees of trust estates), they will be regarded as "non-residents" if their central management and control is not exercised in Hong Kong.

11. The Bills Committee notes that a number of organizations are concerned that the use of "residency" tests for determining profits tax exemption under the Bill does not fit well with the territorial concept of taxation of Hong Kong's taxation regime. Under the concept, only profits derived in Hong Kong from a business carried on in Hong Kong are subject to profits tax regardless of the residence of the individuals or non-individual entities. There is concern that the lack of a clear definition of the term "resident" in the existing IRO will hamper the effective use of the tests. The Administration explains that the proposed residency and "central management and control" criteria are consistent with the widely accepted international practice in exempting offshore funds from tax. The proposed residency tests would be used to determine whether a certain entity could get the profits tax exemption proposed in the Bill. If the entity is not so exempted, its tax liability would still be determined by the territorial source principle (i.e. only profits derived in Hong Kong from a business carried out in Hong Kong would be subject to tax). The Administration confirms that the Bill would not impose any change to Hong Kong's territorial taxation regime. Offshore profits would continue to be not chargeable to profits tax.

12. The Bills Committee has also examined the alternative approaches suggested by some organizations to the residency tests. These approaches include applying the exemption on the basis of the location of the investors in the fund without regard to the residence of the fund itself, and applying the exemption to entities incorporated overseas. Members note that the application of exemption on the basis of location of the investors in the fund is a model similar to the approach adopted in Singapore. The Administration has proposed this model in a previous consultation, and suggested that offshore funds with no more than 20% beneficial interests owned by residents would qualify for exemption. However, this approach was eventually not adopted because of the industry's concern that it would be difficult, if not impossible, for the funds to trace and determine beneficial interests of the ultimate investors. As for the suggestion of applying the exemption to entities incorporated overseas, the Administration considers that the place of incorporation is not an appropriate test to determine whether a fund is an offshore fund since the incorporation of a company outside Hong Kong can be easily arranged. There would likely be abuses with the end result that all corporations' securities trading profits would be exempted from tax by being incorporated overseas.

13. On the application of the criterion of "central management and control" for determining the non-resident status of non-individual entities, the Bills Committee notes the concern expressed by some organizations about the use of the criterion which is not defined in the Bill. There is concern that the application of the criterion would be subject to subjective fact-finding process by the Inland Revenue Department (IRD)

and could result in disputes. In this connection, the Administration explains that the "central management and control" criterion is a well-established common law principle widely adopted in many jurisdictions, such as Singapore, the United Kingdom (UK), Australia and Canada, in determining the residence of non-individual entities. There is a substantial body of case law illustrating how the courts have interpreted the concept of central management and control and how the concept has been applied to factual situations. The adoption of the criterion would allow both taxpayers and IRD to benefit from references to overseas tax cases in the interpretation and application of the criterion. The Administration further advises that it is not necessary and may not be appropriate to set out in the Bill exhaustively the circumstances under which the central management and control of an entity are regarded as being exercised in Hong Kong. A statutory definition may hinder the application of the common law principle to vastly different real life situations and may also not be flexible enough to accommodate future changes. Indeed, jurisdictions, such as Australia, the UK and Singapore, that adopt the same concept for determining the residence for tax purposes also do not define the scope of the concept in their statutes.

14. Nonetheless, to address the organizations' concerns and to facilitate implementation of the proposed exemption, IRD undertakes to issue a Departmental Interpretation and Practice Note (DIPN) upon enactment of the Bill. The DIPN will explain the criteria to be adopted by IRD in determining whether a fund is centrally managed and controlled in Hong Kong with practical examples taking overseas tax cases and practices into account. Under IRD's proposal, the central management and control of a company refers to the highest level of control of the business of the company. Control of a company may be exercised without active involvement in the daily operations of the company's business. Moreover, control may be exercised at a place different from that where the company mainly operates its business. In general, if the central management and control of a company is exercised by the directors in board meetings, the relevant locality is where those meetings are held. In cases where central management and control of a company is in fact exercised by an individual (for example, the board chairman or managing director), the relevant locality is the place where the controlling individual exercises his power. As central management and control is a question of fact and reality, when reaching a conclusion in accordance with case law principles, only factors which exist for genuine commercial reasons will be accepted.

15. Members of the Bills Committee and majority of the organizations welcome the Administration's proposal of issuing a DIPN to clarify the application of the "central management and control" criterion. They consider that the DIPN would provide a clear interpretation of the concept and flexibility to accommodate future changes. On the concern that the DIPN would not have legislative effect, the Administration assures the Bills Committee that as the DIPN would be worked out with reference to the substantial body of case law developed by the courts on the concept, it would be a useful guide in applying the criterion.

16. The Bills Committee notes the concerns raised by some organizations that the asset portfolios of many overseas funds or entities operating in Hong Kong are in fact managed by fund managers in Hong Kong who have been given full discretion to manage these asset portfolios. As such, the central management and control of these funds might be regarded as being exercised in Hong Kong. They might therefore be regarded as residents and hence not qualify for the proposed tax exemption. The Bills Committee is advised by the Administration that the residence of the person who controls and manages the asset portfolios on behalf of a fund or entity is not a conclusive factor in determining the residence of such fund or entity for the purpose of the proposed exemption. Where the central management and control of a fund or a non-individual entity is not exercised in Hong Kong, the fund or entity can qualify for the proposed exemption notwithstanding that its asset portfolios are controlled and managed by a Hong Kong fund manager under his full discretion. However, where an investor company is managed and controlled by fund managers in Hong Kong as directors of the company, the company will be a resident entity as its central management and control is exercised by such directors in Hong Kong.

17. The Bills Committee also notes the view expressed by some organizations that it is a common practice to set up an offshore fund to incorporate a company in an offshore jurisdiction. The company will appoint two Hong Kong fund managers as its only directors, and grant the managers full discretion for dealing in Hong Kong securities. Given that the company's central management and control would be exercised in Hong Kong under such a setup, there is a concern that this kind of funds would not be eligible for the proposed exemption. The Bills Committee notes the Administration's view that a "Hong Kong based fund" with its directors and principal officers exercising central management and control of the fund in Hong Kong is no different from a normal resident company, which is not the intended beneficiary of the proposed exemption for offshore funds. To widen the scope of exemption may lead to abuse and open up the exemption to all local funds.

18. The Bills Committee also notes the concern raised by some organizations that some offshore funds owned by non-residents and establish their central management and control in Hong Kong for dealing in overseas transactions will be regarded as "onshore funds". Any profits derived from their business, whether from Hong Kong or overseas, would be subject to profits tax. The Administration clarifies that the Bill would not impose any new tax liability on onshore funds which are always chargeable to tax in respect of the securities trading profits derived from Hong Kong. However, profits derived offshore are not taxable. The exemption provisions would not render an onshore fund liable to tax in respect of profits made by it offshore, and would only exempt profits which are otherwise chargeable to tax. The exemption provisions do not affect the existing territorial basis of taxation and do not make capital gains (which are exempt under existing law) taxable. The IRD will clarify the position in the DIPN.

19. For illustration purpose, the Administration has provided the Bills Committee with some examples of the taxable entity and the residence in the context of management of investment portfolios for the purpose of the proposed exemption

under the Bill in respect of investments made through various forms of investment vehicles. Such examples are set out in **Appendix III**. The Bills Committee notes IRD's undertaking to incorporate similar examples to clarify the matters in the DIPN.

Specified transactions qualified for the proposed exemption
(Proposed section 20AC and proposed addition of new Schedule 16 to the IRO)

20. The Bills Committee notes that not all transactions carried out by offshore funds are qualified for the proposed exemption. Under the Bill, the specified transactions qualified for the proposed exemption include "dealing in securities", "dealing in futures contracts" and "leveraged foreign exchange trading", i.e. Type 1, 2 and 3 Regulated Activities under the SFO respectively. The Administration's original proposal is to define the term "securities" in the Bill by reference to the same term used in the SFO.

21. The Bills Committee notes the grave concern expressed by some organizations that many common types of activities carried out by offshore funds, such as stock borrowing and lending, placing of deposits in Hong Kong or foreign currencies (which are required for hedging purposes), over-the-counter transactions, non-leveraged foreign exchange trading, commodity and derivative transactions, etc. are not included as specified transactions. Moreover, the definition of the term "securities" would not cover financial instruments such as certificates of deposit, swaps, spot foreign exchange contracts. The organizations are concerned that the narrow scope of specified transactions and definition of the term "securities" in the Bill would undermine the effectiveness of the proposed exemption and would not cater for the development of financial products in the market.

22. To address the concerns of the organizations, the Bills Committee has requested the Administration to examine whether the scope of specified transactions should be expanded and whether adjustment should be made to the definition of the term "securities". As a result of the review, the Administration proposes a Committee Stage amendment (CSA) to add a new Schedule 16 to the IRO, which specifies six types of 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.

23. The term "transactions" will include both exchange-traded transactions and over-the-counter transactions. Profits tax exemption will be allowed by reference to the nature of a financial product traded in the transactions rather than its product name. Details of the transactions covered by the six types of specified transactions are as follows:

(a) "Securities" is defined to mean shares, stocks, debentures, loan stocks, funds, bonds or notes; rights, options or interests in, or in respect of these financial products; certificates of interest in or participation in, certificates for, receipts for, or warrants to subscribe for or purchase these financial products; interests in any collective investment scheme; or interests, rights or property commonly known as securities. The definition will cover different types of options, derivatives and swaps, certificates of deposits, bills of exchanges and promissory notes;

(b) "Futures contract" is defined to cover futures contracts or options on contracts listed or traded on the Hong Kong Futures Exchange Limited; and contracts for differences listed or traded on specified or regulated exchanges;

(c) Transactions in "foreign exchange contract" and "foreign currencies" include transactions in foreign currencies at a future time and transactions in spot foreign currencies respectively. Both leveraged and non-leveraged transactions as well as listed and non-listed contracts are covered;

(d) "Exchange-traded commodities" is defined to mean gold or silver traded on a commodity exchange in Hong Kong; and

(e) "Making of deposits other than by way of a money-lending business" covers money deposits held by offshore funds in their asset portfolios for the normal course of business. Such deposits may be in any currency. Deposits for the purpose of money-lending business are excluded as the normal course of business of an offshore fund should not include carrying on a money-lending business.

24. The Bills Committee notes that the definitions of the terms "securities", "collective investment scheme", and "deposit" provided in the proposed new Schedule 16 to the IRO are different from those for the same terms provided in the SFO and the Banking Ordinance (BO) (Cap. 155). The Administration explains that while reference has been made to the definitions of the three terms in the SFO and the BO in drafting the proposed definitions in the new Schedule 16, the proposed definitions are in fact meant to be separate and independent from those in the SFO and the BO. As the definitions of the three terms in the SFO and the BO have their own regulatory functions to play, they are considered not necessarily appropriate for administering the offshore funds exemption under the IRO. Therefore, the proposed definitions of the three terms in the new Schedule 16 are modified so as to reflect the legislative intent of

providing tax exemption to offshore funds dealing in those instruments.

25. The Bills Committee supports the Administration's proposed CSA. Members note that the proposed new Schedule 16 would cover typical transactions carried out by offshore funds and that the expanded definition of the term "securities" would cover financial products commonly traded by offshore funds. They consider that the proposed CSA has addressed the concerns raised by the organizations. As for future amendments to Schedule 16, the Bills Committee supports the Administration's proposal to move a CSA (proposed section 20AC(7)) to empower the C of IR to amend the Schedule. The amendments to Schedule 16 would be subsidiary legislation subject to the negative vetting procedure of the LegCo. The fund industry also supports the proposal as it will cater for changes in the financial products traded in the market.

26. Some organizations suggest that in order to provide a more embracing exemption regime to offshore funds, the definition of the term "securities" should be further expanded to cover shares and debentures of a private company. The Bills Committee accepts the Administration's view that the suggestion is inappropriate as persons may in effect trade in any types of assets, such as landed property, through transfer of shares in private companies purposely set up for holding such assets. The suggestion would unintentionally widen the scope of exemption and open it to any trading transactions carried out by offshore funds.

Specified transactions carried out through specified persons
(Proposed section 20AC of the IRO)

27. The proposed section 20AC of the IRO provides that specified transactions have to be "carried out through" a specified person in order to be qualified for the proposed exemption. 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. A specified person may be a corporation or an authorized financial institution licensed or registered under the SFO to carry out the above trading activities.

28. The Bills Committee notes the concern of some organizations that the proposed scope of specified person is too restrictive and would not cover transactions "arranged by" the specified persons. There is concern that transactions executed by third party agents upon the instruction of the specified persons would be excluded from the proposed exemption. In order to address the concerns, the Administration agrees to move CSAs to relax the scope of specified person to cover holders of all types of licences under the SFO (proposed section 20AC(8)(b)) and to make it clear that a specified transaction is qualified for exemption so long as it is "carried out through or arranged by" a specified person (proposed section 20AC(2)(b)). The inclusion of the words "arranged by" would cover cases where, for example, a specified person arranges to buy some overseas stocks.

29. Given that the exemption provisions are to apply retrospectively to any year of assessment commencing on or after 1 April 1996, it is suggested that a separate definition be provided for "specified persons" in respect of the period prior to 1 April 2003, the day on which the SFO came into operation. In this connection, the Administration agrees to move a CSA (proposed section 20AC(8)(a)) to provide that before 1 April 2003, 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. These registered or licensed persons under the old law should be accepted as "specified persons" in applying the exemption provisions in respect of the period prior to 1 April 2003.

Incidental transactions carried out by offshore funds
(Proposed section 20AC(1)(b) and (6) of the IRO)

30. Another condition an offshore fund needs to meet in order to be qualified for the proposed exemption is that it must not carry on any other business (except business incidental to the specified transactions) in Hong Kong. In view of the fact that it is not unusual for offshore funds to undertake activities incidental to the exempted business, such entities deriving income incidental to the exempted business in Hong Kong will not be regarded as carrying on other business in Hong Kong. Profits tax exemption for such incidental income will be subject to a de minimis rule. The proposed section 20AC(6) of the IRO provides that if the offshore fund entity's trading receipt from the incidental transactions in respect of a year of assessment exceeds 5% of the total trading receipts from both the specified and incidental transactions, income derived from the incidental business will not be qualified for exemption. Profits from specified transactions remain fully exempt.

31. The Bills Committee notes that some organizations are concerned about the lack of a definition for "incidental transactions", and they suggest the removal of the restriction on offshore funds to carry on other businesses in Hong Kong as well as raising the threshold of the de minimis rule to 20% in order to provide greater certainty to offshore funds and facilitate their operation in Hong Kong. The Administration explains that it will be difficult to provide a definition of "incidental transactions" that can cover all possible modes of operation adopted by different offshore funds. The word "incidental" would be accorded its common meaning, which should provide the desired flexibility to different offshore funds. The Administration further points out that it is common in other tax jurisdictions, such as Singapore, to require an offshore fund not to carry on "other business", since the carrying on of other businesses is not compatible with the ordinary course of business of an offshore fund. As regards the suggestion of raising the threshold of the de minimis rule, the Administration considers that the proposed 5% threshold is appropriate in providing operational convenience to offshore funds as they will not be required to report small amount of otherwise taxable income in respect of incidental transactions. With the widened definition of "specified transactions" mentioned in paragraph 22 above, the 5% threshold would not be easily

exceeded. Moreover, to put beyond doubt that income from non-taxable items under the IRO, such as dividends and interest income, would not be regarded as incidental income for the purposes of calculating the 5% limit, IRD undertakes to clarify this point in the DIPN.

Proposal of applying the exemption provision with retrospective effect
(Proposed section 20AC(1) and proposed section 70AB of the IRO)

32. The Bills Committee notes that under the proposed section 20AC(1) of the IRO, profits tax exemption for offshore fund entities would be applied with retrospective effect to the year of assessment of 1996-97. Moreover, the proposed section 70AB provides that an offshore fund may apply for refund of tax overpaid on the ground that it is entitled to the proposed exemption for the year of assessment 1996-97 or any subsequent years of assessment. The offshore fund may make its application within 12 months after the date of enactment of the Bill, or within six years after the end of the relevant year of assessment, whichever is the later. The Administration explains that such a time limit seeks to strike a balance between finality of an assessment and allowing a taxpayer reasonable time to lodge an application for revision of an assessment. The time limit is consistent with that for lodging an application for revision of an assessment under other sections of the IRO.

33. The Bills Committee notes that the fund industry is strongly supportive of the proposal of applying the exemption provisions with retrospective effect as it will provide offshore funds with legal certainty in respect of their tax liabilities for the past years. The industry considers that without the provision, offshore funds would face huge problems in finalizing their tax liabilities for past years. Boutique funds, in particular, would have financial difficulties in paying the tax for past years. It will also be unfair to existing investors in a fund if they are to bear the tax burden of the fund in relation to past years. However, some members of the Bills Committee have reservation on the proposal. They consider that as a matter of principle, legislative provisions should take effect from the enactment of the relevant ordinance and should not have retrospective effect. They query whether the IRD has taken effective enforcement actions in the past years to recover profits tax payable by offshore funds. They are also concerned about the financial implications of the tax refunds, and whether the refunds may lead to unfair treatment to investors/beneficial owners of the funds.

34. The Bills Committee is advised by the Administration that there are precedents in which legislative amendments for implementing tax concession measures took retrospective effect. Examples include 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, and the Inland Revenue (Amendment) Ordinance 2004, which relaxed the respective criteria for the deduction of home loan interest and self-education expenses with retrospective effect from the year of assessment 1998-99 and 2000-01 respectively.

35. On the current proposal, the Administration advises that it has issued tax returns to some 200 offshore funds for all the relevant years concerned from 1996-97 onwards, and has subsequently raised profits tax assessments on four corporate offshore fund entities. Three of them have duly paid the tax in the total amount of around $18.2 million. The remaining corporation, with tax payable of around $7.5 million, has raised objections against the assessments, and the objections have not been settled. If the retrospective effect of the exemption is adopted, the Administration will need to refund the $18.2 million profits tax already collected from the three corporations if they meet the exemption conditions.

36. As regards the concern about the effectiveness of the enforcement actions taken in recovering profits tax from offshore funds, the Administration points out that due to practical difficulties in the past in obtaining information on share transactions carried out by non-residents, IRD has not been in a position to enforce the relevant provisions effectively in respect of cases where the persons carrying out securities transactions are non-residents. Even if an assessment is raised on a non-resident, IRD would have practical difficulties in recovering the tax from the non-resident who is outside the reach of legal action initiated in Hong Kong. As such, it would be unlikely for IRD to be able to recover tax from such offshore funds even if the exemption provisions have no retrospective effect. The Administration stresses that the proposal is much called for by the fund industry and would not have much adverse effect on the revenue position. On the concern about whether the refund of the collected tax to the relevant offshore funds would lead to unfair treatment to the investors/beneficial owners of the funds, the Administration advises that all the three taxpayers concerned are normal trading corporations and no mutual fund corporation or unit trust is involved. Accordingly, the complexities relating to a trustee's legal liabilities to distribute income and capital to beneficiaries do not arise. Under the law, corporations are legal entities separate from their shareholders, and as such, corporations themselves rather than their shareholders are chargeable to tax and equally are entitled to any tax refund. Any refunds, like those in any other normal cases, would therefore be made to the corporations. By treating the corporation as a separate entity entitled to the refunds, there is no unfair treatment to any investors or shareholders.

37. The Bills Committee has examined whether there are any feasible alternatives to the Administration's proposal. In this connection, some members suggest that, instead of applying the exemption provisions with retrospective effect, the Administration should consider providing an undertaking that it would not recover outstanding or liable profits tax from offshore funds since 1 April 1996. The Administration considers the suggestion not feasible. It points out that IRD has the statutory duty to recover tax from any persons who are liable to pay tax under the provisions of the IRO. IRD has no discretion to waive or forego enforcement of the provisions of the IRO in respect of any charge to profits tax for which any entity in Hong Kong is liable. The suggestion will also lead to unfair treatment to the three corporate taxpayers which have paid the tax as they will not be entitled to any tax refunds. The Administration stresses that applying the exemption provisions with retrospective effect would provide a level playing field among the four corporate taxpayers mentioned in paragraph 35 above and other offshore funds which have

engaged in securities trading transactions in Hong Kong in past years.

38. Noting the strong support of the fund industry for the proposal of applying the exemption provisions with retrospective effect, the practical difficulties in recovering profits tax from offshore funds in the past and the likely substantial costs involved for recovering potential outstanding profits tax from offshore funds, the Bills Committee has no objection to the proposal.

39. The Bills Committee notes that an organization has raised grave concern that IRD may issue profits tax assessments in relation to the past years on boutique funds and hedge funds which do not qualify for exemption when the Bill is enacted, and where IRD has detailed information on hand about those funds. The Administration stresses that all along, any fund which derives securities dealing profits from Hong Kong is chargeable to profits tax in Hong Kong. IRD has the statutory duty to recover tax from any persons who are liable to pay tax under the provisions of the IRO. The proposed retrospective provision does not impose a new tax obligation on the funds. For those funds that satisfy the exemption criteria, the provision would exempt them from tax liabilities retrospectively, and for others that do not satisfy the exemption criteria, no new tax liability would be created but they would continue to be subject to the law hitherto applicable to them.

Deeming provisions

40. To prevent abuse or round-tripping by local funds disguised as offshore funds to take advantage of the exemption, deeming provisions are set out in the Bill to apply to a resident (including an individual or non-individual entity) who owns beneficial interest in an exempt offshore fund of 30% or more (alone or jointly with his associates), i.e. the 30% threshold; or any percentage holding in the offshore fund where the 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.

41. The Bills Committee has examined the need for providing the deeming provisions in the Bill, the impact of the provisions on resident individuals and resident corporations, and the basis for the proposed 30% threshold. In this connection, some organizations have raised concerns on the proposed threshold and also on other issues relating to the deeming provisions, including whether the provisions would result in double taxation on resident persons and the justifications for not allowing resident persons to claim "deemed losses" for the exempted profits tax. The Bills Committee has requested the Administration to address these concerns. Details of the major concerns raised and the Administration's responses are summarized in the ensuing paragraphs.

Need for providing the deeming provisions in the Bill and the impact of such provisions

42. Members share the concern of some organizations that the deeming provisions may add complexity to the taxation regime of Hong Kong. Some organizations also consider that the deeming provisions should not be applied to resident individuals. It is because as the law now stands, resident individuals normally are not subject to profits tax in respect of securities transactions carried out in Hong Kong unless such activities carried out by them constitute a trade, profession or business. Applying the deeming provisions to resident individuals may lead to unintended consequence of widening the tax net.

43. The Bills Committee notes the Administration's view that the exemption provisions are intended to benefit non-residents only. This policy is in line with those of major overseas financial centres such as the UK and Singapore. The deeming provisions have to be enacted to deter residents from carrying out round-tripping to take advantage of the exemption, which is not intended for them. Without the deeming provisions, a Hong Kong resident may avoid tax by simply carrying out securities trading transactions through a non-resident entity.

44. On the concern about applying the deeming provisions to a resident individual, the Bills Committee notes the Administration's clarification that insofar as the individual who carries out share transactions in Hong Kong in his own name is concerned, there is no difference in the tax position before and after enactment of the Bill. After the enactment of the Bill, the same tax position remains. The deeming provisions would not apply to the resident individual who continues to carry out in his own name share transactions which do not amount to the carrying on of a business. The Administration considers that there is little justification for giving preferential tax treatment to individuals by disapplying the deeming provisions to individuals. Beneficial interests in corporations are ultimately held by individuals. A different tax treatment for individuals would create tax-avoidance opportunity.

Threshold for invoking the deeming provisions
(Proposed section 20AE of the IRO)

45. While appreciating that there may be justification for providing the deeming provisions to prevent possible round-tripping transactions carried out by a resident, some members of the Bills Committee express concern on whether the proposed 30% threshold is appropriate. In this connection, some organizations are of the view that the proposed threshold level is too low and suggest that it should be increased to 50%. These organizations point out that without a significant interest in an offshore fund, it would be difficult for the resident person to ascertain information for tax reporting purposes. The Administration explains that in principle, a resident person should be chargeable to tax in respect of any securities trading profits derived from Hong Kong through holding any percentage of beneficial interest in a tax-exempt non-resident entity. However, the Administration recognizes the need to strike a balance between revenue protection and the ease with which taxpayers can comply with the reporting

requirements. If the threshold is too low, a resident person holding a small interest in an offshore fund may have difficulty in obtaining information for reporting deemed profits to IRD. On the other hand, if the threshold is too high, a resident can easily abuse the exemption, which may lead to tax leakage. In the circumstances, the Administration considers that the proposed 30% threshold is reasonable.

46. On the Administration's proposal 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, the Bills Committee notes some organizations' concern that the existing wording of the deeming provisions in the proposed section 20AE(1) and (3) of the IRO 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 has taken on board the organizations' view and agrees to move a CSA to adjust the wording of the deeming provisions (proposed section 20AE (1) and (3)) 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.

47. The Bills Committee also notes that some organizations have raised concern about two issues in the proposed Schedule 15 of the IRO, which provides a formula for ascertaining the amount of assessable profits of resident persons under the proposed section 20AE. An example provided by the Administration on calculation of the deemed assessable profits in respect of a resident person holding beneficial interest in an exempt non-resident entity is given in **Appendix IV**. The first issue which gives rise to concern is that the formula would impose unreasonable obligations on investment managers or trustees requiring them to keep information on the number of units held in a fund on a daily basis in order to facilitate the resident persons to calculate their beneficial interests in the non-resident offshore fund. This would cause difficulty to some offshore funds which only prepare monthly or quarterly accounts. The Bills Committee notes the Administration's view that transfers in or out of units in, and periodic performance of, a fund should have been fully documented. Therefore, in administering an offshore fund, the investment manager or the trustee should possess the information stipulated in the proposed Schedule 15 on the percentage of shareholding or units held by an investor at any particular point in time. The second issue of concern is that resident persons may be liable to a penalty if they report incorrect amount of deemed profits to IRD by relying on information provided by an offshore fund. In this connection, the Administration points out that, under the IRO, a taxpayer would only be imposed a penalty if he fails to perform the legal obligations "without reasonable excuse". IRD, before imposing a penalty, would consider the whole facts and circumstances in deciding whether the resident's reliance on incorrect information provided by the offshore fund constitutes a reasonable excuse. Further, the resident always has the right to appeal against IRD's decision.

Non-profit participating shares held by fund managers

48. The Bills Committee notes some organizations' view 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. These organizations consider that the deeming provisions should not be applied to the management shares since the investment manager does not have any genuine beneficial interest in the fund. 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. In this connection, the Administration proposes to move a CSA (proposed section 20AB(9)) to carve out management shares from the application of the deeming provisions. The Bills Committee and the organizations welcome the proposed CSA.

Escape clause for applying the deeming provisions

49. The Bills Committee notes the proposal put forward by some organizations to provide an escape clause in the Bill to allow a corporation to escape from the deeming provisions if it can justify that no round-tripping is involved. The organizations raise the point that a resident holding company may have a non-resident subsidiary conducting a business overseas independently. The non-resident subsidiary may use the surplus funds derived from its business to deal in Hong Kong securities. It would be difficult for the resident holding company to confirm how the non-resident subsidiary invests its surplus funds and where the relevant profits are sourced. As such, the deeming provisions should not be invoked on the resident holding company.

50. The Bills Committee notes the Administration's response that the organizations' proposal seems to suggest that the deeming provisions should only be invoked where the "funds" (i.e. moneys) used in dealing in Hong Kong securities are sourced from Hong Kong. The Administration points out that administering the deeming provisions by reference to the source of funds is impractical and may open to abuse. "Funds" sourced from Hong Kong can easily be converted into offshore funds by simple arrangements. In real life situations, business "funds" are commonly pooled and become mixed before actual application. Earmarking the source of "funds" is an artificial and elusive process and subject to manipulation. Moreover, similar exemptions offered by other jurisdictions are by reference to non-residency of entities rather than the source of "funds". The Administration also considers that a resident holding company should not have difficulty in obtaining information on the business operation of its non-resident subsidiary. The holding company for legal, accounting or other commercial reasons should always possess sufficient business information on its subsidiary for meeting the reporting requirements under the deeming provisions.

Issue of double taxation

51. The Bills Committee notes the concern raised by some organizations that as a result of the deeming provisions, resident persons may be subject to double taxation in respect of the securities trading income of the exempted offshore funds concerned and the profits made from their eventual disposition of the interest in such exempted funds.

52. According to the Administration, double taxation generally refers to the situation where the same profit is taxed twice in the hands of the same person. This concern should not arise in the scenario highlighted. Where a resident person holds shares in, say, a Hong Kong listed company and makes a profit from the sale of the shares, he would pay tax on the profit only if the profit is revenue in nature (i.e. the profits are derived from a trade or business rather than investment). The listed company would separately pay tax on any share dealing profit it derives. The listed company's share dealing profit is distinctly different from the profit derived by the resident person from the sale of the shares in the listed company. No double taxation should arise. Where the deeming provisions apply to a resident person, the person would pay tax on a portion of the share dealing profits earned by the offshore fund. This is the tax that should have been paid by the offshore fund but for the exemption and also is distinct from the tax, if any, charged on the profits derived by the resident person from the sale of units in the offshore fund. Similarly, there is no double taxation. The Administration further stresses that Hong Kong does not tax dividends and capital gains. The profit derived from the sale of units in an offshore fund is not taxable if the units are held for investment purposes.

Deemed loss available to resident persons

53. The Bills Committee notes the concern of some organizations that there are no provisions in the Bill for resident persons subject to the deeming provisions to claim a deemed loss for off-setting against their other taxable profits. The Administration stresses that the policy objective of the proposed exemption is to attract foreign capital to invest in the local market. The deeming provisions, together with disallowing deemed losses, are intended disincentives to residents for taking benefit from the proposed exemption by round-tripping.

Effective date for the deeming provisions

54. 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. To allow sufficient time for 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 Bills Committee supports the Administration's proposal 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 March 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. To effect the proposal, the Administration will move a CSA to amend subsections (1) and (3) of the proposed section 20AE and to delete subsection (11) of the same section.

Impact of the Bill on onshore funds and local financial services industry

55. Given that the proposal of exempting offshore funds from profits tax may make offshore funds more attractive to investors, some members of the Bills Committee are concerned that the Bill would put onshore funds in a less favourable position. Moreover, by virtue of the "central management and control" criterion, only funds that are centrally managed and controlled outside Hong Kong would benefit from the proposed exemption. As such, there is concern about the negative impact of the Bill on the local financial services industry and related sectors. In this connection, the Bills Committee notes that some organizations have advocated extending the proposed exemption to local funds which have become increasingly popular in recent years. The organizations consider that the extension would encourage the development of Hong Kong based funds companies, help retain the expertise and experience of local fund managers, promote the growth of the local fund management industry. The proposal will bring economic benefits to Hong Kong and provide a level playing field for local and overseas fund management companies operating in Hong Kong.

56. The Bills Committee notes the Administration's advice that further widening of the scope of exemption to open it up to local funds will not be in line with the policy intention of giving tax exemption to offshore funds only. Moreover, the Administration is not aware that any major financial centres offer exemption to onshore funds. The Administration also points out that, as the Bill specifically provides that tax exemption is granted in respect of specified transactions which are carried out through a licensed corporation or a registered financial institution, the local fund industry and financial service sector would benefit from the proposal. The proposed exemption would also strengthen Hong Kong's competitiveness in attracting new offshore funds to Hong Kong and encourage existing offshore funds to continue to invest in Hong Kong. Downstream services sectors such as those provided by brokers, accountants, bankers, lawyers, etc. will also benefit from the proposal. The proposal would lead to an increase in market liquidity and employment opportunities in the financial services and related sectors.

Committee Stage amendments

57. The Bills Committee supports the CSAs proposed by the Administration. The Bills Committee has not proposed any CSAs.

58. The Bills Committee has also invited the organizations concerned to give their written views on the technical aspects of the CSAs proposed by the

Administration. The Bills Committee notes from the organizations' written submissions that they are generally supportive of the CSAs.

Recommendation

59. The Bills Committee supports the Administration's proposal that the Second Reading debate on the Bill be resumed on 1 March 2006.

Consultation with the House Committee

60. The House Committee, at its meeting on 10 February 2006, supported the recommendation of the Bills Committee in paragraph 59 above.

Council Business Division 1
Legislative Council Secretariat
22 February 2006

附錄I
Appendix I

《2005年收入(豁免離岸基金繳付利得稅)條例草案》委員會
Bills Committee on Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005

委員名單
Membership List

主席 **Chairman**	田北俊議員, GBS, JP	Hon James TIEN Pei-chun, GBS, JP
委員 **Members**	呂明華議員, SBS, JP	Dr Hon LUI Ming-wah, SBS, JP
	陳智思議員, JP	Hon Bernard CHAN, JP
	陳鑑林議員, SBS, JP	Hon CHAN Kam-lam, SBS, JP
	單仲偕議員, JP	Hon SIN Chung-kai, JP
	黃宜弘議員, GBS	Dr Hon Philip WONG Yu-hong, GBS
	林健鋒議員, SBS, JP	Hon Jeffrey LAM Kin-fung, SBS, JP
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	湯家驊議員, SC	Hon Ronny TONG Ka-wah, SC
	詹培忠議員	Hon CHIM Pui-chung
	譚香文議員	Hon TAM Heung-man
	(總數：11位委員) (Total : 11 members)	
秘書 **Clerk**	司徒少華女士	Ms Connie SZETO
法律顧問 **Legal Adviser**	馮秀娟女士	Ms Connie FUNG
日期 **Date**	2005年7月15日 15 July 2005	

Appendix II

Bills Committee on
Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005

List of organizations and individual submitted views on the Bill

* 1. Capital Markets Tax Committee of Asia
* 2. British Chamber of Commerce in Hong Kong
* 3. Clifford Chance
* 4. The Hong Kong Society of Financial Analysts Limited
* 5. Ernst & Young Tax Services Limited
* 6. PricewaterhouseCoopers Ltd.
7. Hong Kong Institute of Certified Public Accountants
* 8. Deloitte Touche Tohmatsu
* 9. Hong Kong Investment Funds Association
* 10. KPMG Tax Limited
* 11. The Taxation Institute of Hong Kong
* 12. The Alternative Investment Management Association (Hong Kong Chapter)
* 13. Hong Kong General Chamber of Commerce (Taxation Committee)
14. CPA Australia, Hong Kong China Division
15. The Law Society of Hong Kong
16. The Association of Chartered Certified Accountants (Hong Kong)
17. Hong Kong Venture Capital and Private Equity Association
18. The Hong Kong Association of Banks
19. Mr David GUNSON
* 20. Goldman Sachs (Asia) L.L.C.
* 21. SINOPIA Asset Management (Asia Pacific) Limited
* 22. Deacons
* 23. Hong Kong Stockbrokers Association Limited

Remark:
"*" denotes those organizations the representatives of which have attended a Bills Committee meeting.

Appendix III

Taxable entity and residence under the Offshore Funds Exemption Bill

e.g.	Investor	Investment Vehicle	Management of Investment Vehicle (Note [1])	Fund Management	Taxable Entity	Residence of Taxable Entity
1.	Individual A not ordinarily or temporarily resides in Hong Kong	Funds remitted directly to HK Fund Manager	N.A.	Licensed Hong Kong Fund Manager with full discretion	Individual A (**Note [2]**)	**Non-resident**
2.		Trust set up in Cayman Islands	Trustee B resides in Cayman Islands		Trustee B	
3.		Mutual fund corporation C set up in Cayman Islands	Board of directors in Cayman Islands		Mutual Fund Corporation C	
4.	Company D carrying on other business in London; managed by a board of directors there	Funds remitted directly to HK Fund Manager	N.A.	Licensed Hong Kong Fund Manager with full discretion	Company D	**Non-resident**
5.		Trust set up in Cayman Islands	Trustee E resides in Cayman Islands		Trustee E	
6.		Mutual fund corporation F set up in Cayman Islands	Board of directors in Cayman Islands		Mutual Fund Corporation F	
7.	Offshore investors	Private Company G incorporated in BVI	Board of directors comprising only 2 HK fund managers in HK	2 licensed Hong Kong Fund Mangers (the directors) with full discretion	Company G	**Resident** (centrally managed and controlled in HK)

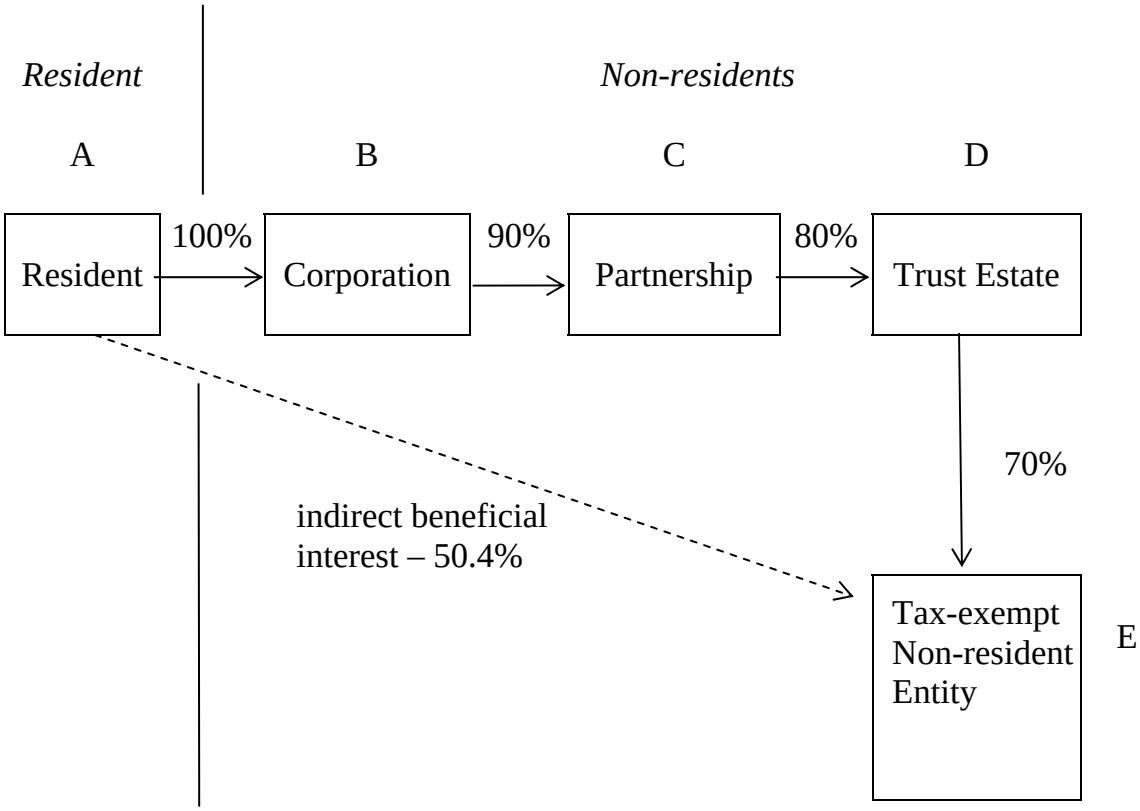
[1] The relevant board of directors can remove the fund manager, monitors and evaluates the fund manager's performance, and may direct the funds to be invested in other countries. In the case of a trust, the relevant trustee is legally in charge of the trust estate and ultimately responsible to the beneficiaries (i.e. unit holders). He supervises the operation of the trust to ensure compliance with the trust's constitutive documents, ensures that the fund manager complies with the investment strategy, reviews the fund manager's performance and has the power to remove the fund manager in accordance with the relevant provisions in the trust deed. The mere outsourcing of back office administrative work by the trustee to a service provider in Hong Kong will not affect its residence.

[2] The residence of an individual is based on the "ordinary or temporary residence" test and not the "central management and control" test. This example is added for the sake of completeness.

e.g.	Investor	Investment Vehicle	Management of Investment Vehicle (Note [1])	Fund Management	Taxable Entity	Residence of Taxable Entity
8.	Offshore investors	Private Company H incorporated in BVI	Board of directors comprising HK fund managers and other non-resident persons, holding majority of board meetings (through which central management and control is exercised – footnote 1) outside HK	Licensed Hong Kong Fund Mangers (the directors) with full discretion	Company H	**Non-resident**
9.	Offshore investors	Limited partnership J set up in BVI	Non-resident general partners only; limited partners [may include resident persons] have no management rights	Licensed Hong Kong Fund Mangers with full discretion	Limited partnership J	**Non-Resident** (centrally managed and controlled outside HK)
10.	Company K incorporated in Japan and managed by a board of directors there; deals in home appliances	Branch set up in Hong Kong – sells home appliances and deals in HK securities	Company K itself in Japan	Licensed Hong Kong Fund Manager with full discretion	Company K	**Non-resident**, but **no exemption** since selling of home appliances is a separate business
11.	Global fund Institution L incorporated and managed by a board of directors outside HK; invests in the global securities markets	A portion of the global funds remitted directly to HK Fund Manager; no investment vehicle is set up	N.A.	Licensed Hong Kong Fund Manager with full discretion	Institution L	**Non-resident**

(*Source*: Annex A to Appendix 1 of the Administration's information paper (LC Paper No. CB(1)44/05-06(22)).

Offshore Funds Exemption – Deeming Provisions
Resident holding indirect beneficial interest
in a tax-exempt non-resident through interposed persons



Note: ⟶ means direct beneficial interest

E is a non-resident entity. During the accounting year ended 31 March 2006, E makes profits of $36.5 million from securities trading transactions in Hong Kong, which would have been chargeable to profits tax but for the exemption provisions. A resident person, A, holds beneficial interest in E through certain non-resident persons from 1 to 31 March 2006. The amount of A's deemed assessable profits under Schedule 15 is-

$$\frac{\$36.5M \times (100\% \times 90\% \times 80\% \times 70\%)}{365 \text{ days}} \times 31 \text{ days} = \underline{\$1.5624M}$$

(*Source*: Annex B to Appendix 1 of the Administration's information paper (LC Paper No. CB(1)44/05-06(22)).