

Bills Committee on Inland Revenue (Amendment) (No. 3) Bill 2013
Follow-up to meeting on 28 January 2014

Purpose

This paper sets out the Administration's responses to Members' questions raised at the meeting on 28 January 2014.

Background

2. The Financial Secretary proposed in the 2013-14 Budget to reduce the profits tax of the business of insurance¹ of offshore risks of captive insurers such that they will enjoy the same tax concessions under the Inland Revenue Ordinance ("IRO") (Cap. 112) currently applicable to reinsurers (i.e. one-half of the normal tax rate for corporations which is currently at 16.5%). The policy objective of providing tax concessions to captive insurers is to attract more enterprises to set up captive insurers in Hong Kong. This will not only reinforce Hong Kong's status as a regional insurance hub, but also foster further development of other related businesses, including reinsurance, brokerage, accounting, legal and actuarial services, making Hong Kong's risk management services more diversified.

The Administration's responses

3. The Administration's responses to Members' questions according to the checklist prepared by the Clerk to the Bills Committee are set out in pursuing paragraphs.

Rationale for setting the proposed profits tax concession

(1a) the rationale for setting the proposed profits tax rate at one-half of the normal tax rate for corporations which is currently 16.5%

(1b) the reasons for only applying the proposed concessionary profits tax rate to captive insurer pertaining to their business of insurance and reinsurance of offshore risks but not onshore risks

4. Tax concession should not be widely used in an unscrupulous manner as an incentive to promote a certain type of business in Hong Kong. At present, tax concession is accorded to

¹ Generally, the insurance industry takes that insurance also includes reinsurance.

reinsurance business of offshore risks only. When considering tax incentive to promote captive insurance in Hong Kong in response to the insurance industry's suggestion, we have drawn reference to the profits tax reduction for offshore risks currently applicable to reinsurers.

5. We will continue to keep under review the need for further measures to promote captive insurance business in Hong Kong in the light of market developments.

Comparison and Competitiveness

(1c) comparison of the proposed concessionary profits tax rate and other regulatory concessions granted to captive insurers by Hong Kong and other jurisdictions; and explain how Hong Kong would maintain its competitiveness in attracting captive insurers vis-à-vis other jurisdictions

6. A summary of concessions given to captive insurers in different jurisdictions is set out below –

Singapore: Profits tax on captive insurers' offshore business is waived for 10 years. Regulatory concessions for captive insurers include lower capital requirement, lower solvency requirement, exemption from Insurance (Valuation and Capital) Regulations and lower licensing fees.

Labuan Island, Malaysia: Profits tax of 3% or a maximum of MYR20,000 (approximately HK\$50,000).

Qatar: No profits tax for captive insurers' business.

Delaware, USA: Concessionary tax rate for captive insurers' business – 0.2% for direct business, capped at US\$125,000 (approximately HK\$970,000); 0.1% for reinsurance business, capped at US\$75,000 (approximately HK\$580,000).

7. Other regulatory concessions for captive insurers as compared to non-life insurers under our existing regime are –

Item	Captive Insurer	Non-life Insurer
Minimum Capital Requirement	HK\$2 million	HK\$10 million
Minimum Solvency Margin	The greatest of: a. 5% of the premium income; or b. 5% of the claims outstanding; or c. HK\$2 million	The greatest of: a. generally 20% of the premium income; or b. generally 20% of the claims outstanding; or c. HK\$10 million
Requirement for Assets in Hong Kong	Exempted	To maintain assets in Hong Kong of an amount not less than 80% of its Hong Kong net liabilities plus solvency margin
Valuation Regulation	Assets and liabilities to be valued on the basis of Generally Accepted Accounting Principles	Assets and liabilities to be valued according to the Insurance Companies (General Business) (Valuation) Regulation
Authorization and Annual Fee	HK\$ 22,600	HK\$ 227,300

8. When assessing our attractiveness as a domicile for captive insurance, we have to take into account our fundamental strengths as an international financial centre, including a simple tax regime, rule of law, ready supply of talent, free flow of information and capital and a highly open and competitive operating environment.

(1d) whether the proposed tax concession is targeted at attracting captive insurers from particular jurisdictions, such as the Mainland, to establish in Hong Kong

9. The Administration and the insurance industry regularly exchange views on how to further promote the sustainable development of the industry. The insurance industry considers that with a robust regulatory regime and easy access to the reinsurance market, Hong Kong has the potential to become a domicile of captive insurers. Given other jurisdictions are offering tax concessions to promote captive business, the industry has proposed that the Government should consider offering tax concessions to attract enterprises to choose Hong Kong as the domicile

for captive insurers. The industry has also pointed out as Mainland enterprises are becoming more internationalised and sophisticated, they will increasingly use captive insurance for reducing insurance cost and better risk management. Being proximate to the Mainland, Hong Kong will benefit from the anticipated growth in the use of captive insurance by Mainland enterprises.

10. The initiative to offer tax concession for captive insurers is the Administration's positive response to the industry's proposal. We agree to the industry's assessment that Mainland enterprises will consider Hong Kong as a desirable domicile for its captive insurance operation given the proximity effect.

(1e) some members' views that the Administration should make reference to other jurisdictions to exempt captive insurers from all profits tax (e.g. Singapore) or exempt them from such tax in the first two years of their operation in Hong Kong

11. As explained in paragraph 9 above, tax concession is only one of many factors of consideration in choosing the domicile of a captive insurance operation by enterprises. Having said that, we will continue to keep under review the need for further measures to promote captive insurance business in Hong Kong in the light of market developments.

Definition of captive insurance business eligible for the proposed tax concessions and "offshore risk"

(2a) explain the appropriateness to adopt the definition of "the same group of companies" under ICO for the purpose of the proposed tax concessions, having regard to the concern that the percentage of controlling stake (i.e. not less than 20%) in question may be over generous and have implications on tax revenue

(2b) provide information on the definition of "same grouping of companies" or other relevant definitions adopted by other jurisdictions for the purpose of granting profits tax concessions to captive insurers

12. In Hong Kong, a captive insurer is legally defined under the Insurance Companies Ordinance ("ICO") (Cap. 41) as an insurer which carries on general business only, and is restricted to underwriting

insurance of risks of the companies within the same grouping to which the captive insurer belongs. An extract of the statutory definition is at **Annex**.

13. The definition of captive insurance business and “same grouping of companies” varies among jurisdictions. In Singapore, according to section 6 of the Companies Act of Singapore, the definition of “same grouping of companies” includes subsidiary companies (i.e. with a controlling stake of more than 50%). Details are as follows–

Where a corporation –

- (a) is the holding company of another corporation;
- (b) is a subsidiary of another corporation; or
- (c) is a subsidiary of the holding company of another corporation,

that the first-mentioned corporation and that other corporation shall be deemed to be related to each other.

14. In Bermuda, in addition to subsidiary companies with controlling stake of not less than 50%, the “same grouping of companies” includes financial relationships. Details are as follows–

Group means a group of companies –

- (a) that consists of a participating company, its subsidiaries and any entities in which the participating company or its subsidiaries hold a participation; or
- (b) that is based on the establishment, contractually or otherwise, of strong and sustainable financial relationships among those companies.

15. Regarding the question on whether our regime is too generous, we note that in Singapore, business of a captive insurer should deal principally with risks of its related corporations. However, a captive insurer can also write risks of companies which are associates of its group, i.e. with a 20% controlling stake, if such business does not amount to more than 20% of the captive insurer’s total business (in terms of gross premium).

16. Bermuda allows a captive insurer to be wholly owned by two or more unrelated persons which intends to carry on insurance business with not less than 80% of its business (in terms of net premiums) covering risks of any of those persons or their affiliates. In other words, captive insurers are allowed to write 20% of business not related to their group.

17. In Labuan, Malaysia, a captive insurer may underwrite business risks of their own group; or third party risks, subject to Labuan Financial Services Authority's approval.

18. Therefore, it appears that our definition of "same grouping of companies" (i.e. "not less than 20% controlling stake") and restriction of acceptance of risk only from the same grouping of companies are no less stringent than those in other jurisdictions.

(2c) consider the need to provide a definition of "offshore risks" in the Bill, with reference to major tax cases in other jurisdictions involving disputes/loopholes over the scope of "offshore risks"

19. Whether an insured risk is located outside Hong Kong is a question of fact to be decided on a case by case basis. Since it is a question of fact, any artificial steps to alter the location of a risk is unlikely to succeed in the presence of the anti-avoidance provisions under the IRO, in particular, sections 61 and 61A.

20. Experience from overseas tax jurisdictions shows that abuse cases are often related to artificial or exceptionally high payments of premiums to captive insurers for tax avoidance purposes². We are not aware of tax avoidance cases taking advantage of the scope of "offshore risks". In any case, since offshore risks are normally related to offshore profits not subject to Hong Kong taxation, tax abuses through the concessionary regime are not likely to arise.

Section 39E of the IRO

(3) In light of the proposed tax concessions for captive insurance business of offshore risks, the Administration is requested to respond to some members' views that similar considerations should be given to relaxing the restrictions under section 39E of

² For example, the UK case of *DSG Retail Ltd and others v Revenue and Customs Commissioners* [2009] STC (SCD) 397.

IRO for granting depreciation allowances to a Hong Kong enterprise if the machinery or plants owned the enterprise are used wholly or principally outside Hong Kong by another enterprise under a leasing arrangement.

21. Some industry sectors and LegCo Members proposed to relax section 39E of IRO in order to allow Hong Kong enterprises engaging in “import processing” arrangements to claim depreciation allowances for machinery and plant made available for use by the Mainland enterprises rent-free. Nevertheless, given Hong Kong’s established taxation principles of “territorial source” and “tax symmetry”, as well as the problem of transfer pricing, the Administration considers that there are no justifiable grounds to relax the existing restriction in section 39E of the IRO.

Drafting of sections 2(2), 2(4), 4(2) and 4(4) of the proposed Schedule 30 to IRO

(4) In light of comments of the Legal Adviser to the Bills Committee, the Administration is requested to explain the drafting of sections 2(2), 2(4), 4(2) and 4(4) of the proposed Schedule 30 to IRO with regard to the usage of “the ground is...” (English text) and “有關理由是” (Chinese text), which seems to depart from the drafting of similar provisions in other parts of IRO (e.g. existing section 3(4) of Schedule 25).

22. As a plain language initiative, the Law Drafting Division of the Department of Justice has, where appropriate, sought to avoid unnecessary cross-referencing to enhance simplicity and conciseness of the law. One way of doing so is to rely on a narrative style of drafting. This drafting style has been adopted for sections 2 and 4 of the proposed new Schedule 30 to the IRO. The beginning article “[t]he” and the beginning characters “有關” in the respective subsections (2) and (4) of those sections indicate clearly to the readers that those subsections are not meant to be independent and read alone. Indeed, they are the continuation of the narratives created in the respective previous subsections.

23. Using section 2 of Schedule 30 as an illustration, subsection (1) refers to “the ground specified in subsection (2)” and this is the only place where that reference is made throughout the provision, so it is beyond doubt that “[t]he ground” in subsection (2) means the one referred

to in subsection (1). Subsection (3) refers to “the ground specified in subsection (4)” and this breaks the previous narrative and creates a new one. This is also the only place where that reference is made throughout the provision, so it is beyond doubt that “[t]he ground” in subsection (4) means the one referred to in subsection (3). The phrases “specified in subsection (2)” in subsection (1) and “specified in subsection (4)” in subsection (3) already remove any room of possible confusion or ambiguity. The same explanation can be applied to section 4 of Schedule 30 as well. Given there would be practically no room for ambiguity or confusion as to what “the ground” (in the English text) and “有關理由” (in the Chinese text) in subsections (2) and (4) refer to, we consider it desirable to skip the extra cross-referencing words like “specified for the purposes of subsection (x)” in those subsections, and simply rely on the narratives created in the previous subsections.

Resumption of Second Reading Debate of the Bill

24. Members are advised to note the information provided above. The Administration proposes to resume Second Reading Debate of the Bill on 19 March 2014.

Financial Services and the Treasury Bureau
14 February 2014

Annex

Section 2(7) of the Insurance Companies Ordinance (Cap. 41)

(7) For the purpose of this Ordinance-

- (a) ***captive insurer*** (專屬自保保險人) means a company (***relevant company***) which carries on general business only and such business-
 - (i) does not relate to any liabilities or risks in respect of which persons are required by any Ordinance to be insured; and
 - (ii) is restricted to the insurance and reinsurance of risks of the companies within the same **grouping** of companies to which the relevant company belongs;
- (b) the following companies shall be regarded as within the same **grouping** of companies to which the relevant company belongs-
 - (i) a company (***first company***) which belongs to the relevant company's **group** of companies;
 - (ii) a company (***second company***) in respect of which the relevant company or the first company holds, or is entitled to control the exercise of, not less than 20% but not more than 50% of the voting power at any general meeting of the second company;
 - (iii) a company (***third company***) where the third company is a subsidiary of the second company;
- (c) ***group of companies*** (公司集團) has the meaning assigned to it under section 2 of the Companies Ordinance (Cap 32). (Added 29 of 1997 s. 2)

Section 2 of Companies Ordinance (Cap. 32)

“group of companies” (公司集團) means any 2 or more companies or bodies corporate one of which is the holding company of the other or others; (Added 6 of 1984 s. 2)