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**Report of the Bills Committee on Inland Revenue
(Amendment) (No. 3) Bill 2013**

Purpose

This paper reports on the deliberations of the Bills Committee on the Inland Revenue (Amendment) (No. 3) Bill 2013 ("the Bills Committee").

Background

Proposed tax concession for captive insurers under the 2013-14 Budget

2. Captive insurance is a form of self-insurance by companies. A company may wish to set up a captive insurer to provide coverage of specific risks that is not readily available in the market. As a captive insurer can operate with a lower overhead (e.g. no marketing expenses and commission to insurance intermediaries) and profit margin, it may charge a lower premium and the parent company can also share the underwriting profits of the captive insurer.

3. In the 2013-14 Budget, the Financial Secretary proposed to reduce the profits tax on the offshore risk insurance business of captive insurance companies so that they will enjoy the same tax concessions under the Inland Revenue Ordinance (Cap. 112) ("IRO") as those currently applicable to reinsurance companies (i.e. one-half of the normal tax rate for corporations which is currently at 16.5%). According to the Administration, it consulted the Insurance Advisory Committee on the tax concession proposal in August 2013 and obtained its support.

Increasing the deduction ceiling for contributions to recognized retirement schemes

4. Section 16AA of IRO provides for the deduction of mandatory contributions by self-employed persons ("SEPs") for the purpose of calculating their tax payable under profits tax. Section 26G of IRO provides for the deduction of contributions to recognized occupational retirement schemes and mandatory contributions to the Mandatory Provident Fund ("MPF") Schemes by employees for the purposes of calculating tax payable under salaries tax or tax under personal assessment. The maximum amount of allowable deduction under section 16AA or 26G of IRO for each year of assessment is prescribed in Schedule 3B to IRO. It is currently set at \$15,000 (i.e. \$25,000 x 5% x 12 months).

5. On commencement of the Mandatory Provident Fund Schemes Ordinance (Amendment of Schedule 3) Notice 2013 on 1 June 2014, the maximum relevant income level under the Mandatory Provident Fund Schemes Ordinance (Cap. 485) ("MPFSO") will be increased from \$25,000 to \$30,000 per month. Following this, the Administration proposes to increase the deduction ceiling for contributions¹ to recognized retirement schemes from \$15,000 to \$17,500 for the year of assessment 2014/15 (i.e. \$25,000 x 5% x 2 months + \$30,000 x 5% x 10 months), and to \$18,000 from the year of assessment 2015/16 onwards (i.e. \$30,000 x 5% x 12 months).

The Bill

6. For the purpose of implementing the two proposals in paragraphs 3 and 5 above, the Administration gazetted the Bill on 27 December 2013 which received First Reading in the Legislative Council ("LegCo") meeting of 8 January 2014. The main provisions of the Bill are as follows-

- (a) *Clause 3*: provides that the profits tax concession for captive insurers applies to the year of assessment commencing on 1 April 2013 and to all subsequent years of assessment;
- (b) *Clause 4*: amends section 14B of IRO to allow a corporation's assessable profits that are derived from the business of insurance of offshore risks as a captive insurer to be chargeable to profits tax at one-half of the normal rate;

¹ Contributions include: (a) mandatory contributions by a SEP under MPFSO; (b) the lesser of the amount of the contributions paid by a person as an employee to a recognized occupational retirement scheme or the amount he would have been required to pay if at all times whilst an employee during the relevant year of assessment he had contributed as a participant in a mandatory provident fund scheme; and (c) mandatory contributions by an employee to a mandatory provident fund scheme under MPFSO.

- (c) *Clause 6*: amends section 23A of IRO to provide for the formula for ascertaining a captive insurer's assessable profits that are derived from the business of insurance of offshore risks;
- (d) *Clause 7*: amends Schedule 3B to IRO to raise the maximum amount deductible from assessment income for the following contributions –
 - (i) mandatory contributions paid by any SEP under MPFSO; and
 - (ii) certain contributions paid by any person to a recognized retirement scheme as an employee; and
- (e) *Clauses 8 and 9*: add a new Schedule 30 to IRO to provide for the transitional arrangements relating to the holding over of payment of provisional salaries tax and provisional profits tax, on the ground of the taxpayer's entitlement to the rise in deduction ceiling for contributions to recognized retirement schemes, for the years of assessment 2014/15 and 2015/16.

7. The Bill, if passed, would come into operation on the day on which it is published in the Gazette.

The Bills Committee

8. At the House Committee meeting on 10 January 2014, Members agreed to form a Bills Committee to study the Bill. The membership list of the Bills Committee is at **Appendix I**. Under the chairmanship of Hon WONG Ting-kwong, the Bills Committee has held two meetings with the Administration to discuss the Bill.

Deliberations of the Bills Committee

Proposed tax concession for captive insurers

9. The Bills Committee supports the proposal to provide captive insurers a concessionary profits tax rate for their business of insurance of offshore risks. The major deliberations of the Bills Committee are summarized in the ensuing paragraphs.

Benefits of the proposal for Hong Kong

10. The Bills Committee notes that the policy objective of providing tax concession to captive insurers is to attract more enterprises to set up captive insurers in Hong Kong. In this regard, members of the Bills Committee have examined the benefits for Hong Kong with an increase in the number of captive insurers domiciled in Hong Kong. Members have also sought information from the Administration on the forecast tax revenue forgone as a result of the proposed tax concession, and the estimated number of captive insurers to be attracted by the proposal to establish in Hong Kong, in particular, Mainland enterprises given the policy support by the Central People's Government in June 2012 to encourage Mainland enterprises to form captive insurers in Hong Kong to enhance their risk management.

11. On the benefits of the proposal, the Administration has advised that while captive insurance has been widely used as a risk management tool in advanced economies, its utilization in Asia remains low. Attracting enterprises to set up captive insurers in Hong Kong to form a cluster will not only help the development of other related businesses, including reinsurance, legal and actuarial services, making Hong Kong's risk management services more diversified, but also reinforce Hong Kong's status as a regional insurance hub. The Administration considers that with a sound regulatory regime and availability of a wide range of professionals, Hong Kong is well positioned to establish herself as a domicile for captive insurers.

12. As regards the impact on tax revenue, the Administration has responded that it will be difficult to provide such information at this stage as there are currently only two captive insurers² in Hong Kong. The Administration will monitor new developments and review the situation after implementation of the proposal for some time.

13. In respect of the number of enterprises to be attracted to establish their captive insurers in Hong Kong, the Administration has pointed out that it would be difficult to estimate the likely number of applications at this juncture as enterprises may take into account tax rates and other factors when deciding where to set up their captive insurers. Nevertheless, the Insurance Authority ("IA") has received quite a number of enquiries concerning the establishment of captive insurers in Hong Kong since the announcement of the proposed tax incentive in the 2013-14 Budget. The Administration has advised that there are currently over 6,000 captive insurers established in the world with majority of them domiciled in Bermuda and Cayman Islands. The proposed tax concession aims to attract more enterprises to establish their captive insurers in Hong Kong. According to the insurance industry, as Mainland enterprises are

² CNOOC Insurance Limited (authorized on 5 December 2000) and Sinopec Insurance Limited (authorized on 31 October 2013).

becoming more internationalized 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. As far as the Administration is aware, at least three Mainland enterprises have set up captive insurers to underwrite their own risks. The proposed tax incentive, coupled with the policy promulgated by the State Council in June 2012 to encourage Mainland enterprises to form captive insurers in Hong Kong, would provide impetus for Mainland enterprises to consider setting up captive insurers in Hong Kong.

Proposed concessionary profits tax rate for captive insurers

14. Noting that a number of jurisdictions have offered more attractive tax concessions for captive insurers (e.g. Singapore has waived profits tax on captive insurers' offshore business for 10 years) than the proposed profit tax of 8.25% in Hong Kong (i.e. half of the normal tax rate for corporations which is currently at 16.5%), some members of the Bills Committee are concerned about Hong Kong's competitiveness in attracting captive insurers vis-à-vis other jurisdictions. The Bills Committee has requested the Administration to explain the rationale for setting the proposed concessionary profits tax rate, the reasons for only applying the proposed concession to captive insurers pertaining to their business of insurance of offshore risks but not onshore risks, and to compare the tax concessions granted to captive insurers by Hong Kong and other jurisdictions.

15. The Administration has responded that at present, tax concession is accorded to reinsurers pertaining to their business of offshore risks only. When considering tax incentive to promote captive insurance in Hong Kong in response to the insurance industry's suggestion, the Administration has drawn reference to the profits tax reduction for offshore risks currently applicable to reinsurers. The Administration has assured members that it will continue to keep under review the need for further measures to promote captive insurance business in Hong Kong in light of market developments.

16. On the comparison of tax concessions given to captive insurers in different jurisdictions, the Bills Committee notes that Singapore has waived profits tax on captive insurers' offshore business for 10 years, Bermuda has no corporate tax, whereas Qatar does not impose any profits tax on captive insurers' business. Bills Committee members further note that in Labuan Island (Malaysia), profits tax of 3% or a maximum of MYR20,000 (approximately HK\$50,000) is imposed on captive insurers. In Delaware (the United States), concessionary tax rates for captive insurers' direct business and reinsurance business are 0.2% and 0.1% with caps at US\$125,000 (approximately HK\$970,000) and US\$75,000 (approximately HK\$580,000) respectively. Referring to the more favourable concessionary tax rates

provided by the above jurisdictions, some members of the Bills Committee consider that the Administration should offer tax concessions of a greater magnitude so as to enhance Hong Kong's attractiveness to captive insurers vis-à-vis other jurisdictions which have been implementing tax concessions for a number of years. Suggestions in this regard include exempting captive insurers from all profits tax or waiving their profits tax in the first two years of their operation in Hong Kong.

17. The Administration has stressed that in assessing the attractiveness of a jurisdiction for captive insurers, tax concession is only one of the many factors of consideration and other regulatory concessions for captive insurers should be considered. In this respect, as compared to ordinary non-life insurers, the Hong Kong regulatory regime has provided concessions to captive insurers in terms of lower capital, solvency margin requirements and fees, etc. A full set of the regulatory concessions and the comparison with the requirements for ordinary non-life insurers are given in **Appendix II**. Furthermore, the Administration has pointed out that Hong Kong's 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, are competitive advantages that should be taken into account. Nonetheless, the Administration has reiterated that the current proposal is only a first step to attract enterprises to set up captive insurers in Hong Kong and it will continue to keep under review the need for further measures to promote captive insurance business in Hong Kong in light of market developments.

18. In light of the proposed tax concessions for captive insurance business of offshore risks, Mr Andrew LEUNG has pointed out that the same principle should apply to the case where a Hong Kong enterprise engaging in "import processing" arrangements in leasing its machinery or plant to an enterprise outside Hong Kong which belongs to the same group of companies of the Hong Kong enterprise. He is of the view that similar consideration should be given to relaxing the restrictions under section 39E of IRO in order to allow Hong Kong enterprises engaging in "import processing" arrangements to claim depreciation allowances for machinery or plant made available for use by the Mainland enterprises rent-free.

19. The Bills Committee notes the Administration's response that there are no justifiable grounds to relax the existing restriction in section 39E of IRO given Hong Kong's established taxation principles of "territorial source" and "tax symmetry", as well as the problem of transfer pricing. According to the "territorial source" principle, profits tax would not be charged on Hong Kong enterprises in relation to Mainland enterprises' production activities. Based on the "tax symmetry" principle, depreciation allowances for the machinery or plant used by the Mainland enterprises in their production activities would not be granted. From the international perspective, the tax authorities around the

world (including the State Administration of Taxation of China) are all increasingly concerned about the transfer pricing issue arising from cross-border trading activities between associated enterprises.

Definition of captive insurer and the scope of the proposed concessionary tax regime

20. The Bills Committee notes that in providing the proposed concessionary profits tax rate to captive insurers, the Administration has adopted the same definition of captive insurer under section 2(7) of the Insurance Companies Ordinance (Cap. 41) ("ICO"), i.e. an insurer which carries on general business only and is restricted to underwriting insurance of risks³ of the companies within the same grouping of companies to which the captive insurer belongs. In other words, the proposed concessionary profits tax rate will apply to the captive insurer's business of offshore risks from the same grouping of companies to which it belongs. As provided in section 2(7)(b) of ICO, "same grouping of companies" to which the captive insurer belongs may include a company which the captive insurer or any company belonging to the same group holds, or is entitled to control the exercise of, not less than 20% of the voting power at any general meeting. Given the low percentage of controlling stake (i.e. not less than 20%) in question, some members of the Bills Committee are concerned whether the scope of the proposed tax concession would be too wide, thereby has implications on tax revenue. The Bills Committee has requested the Administration to examine the appropriateness to rely on the definition of captive insurer under ICO for granting the proposed tax concession with reference to comparable definitions of "captive insurance business" and "same grouping of companies" used by other jurisdictions.

21. The Administration has advised that the definitions of "captive insurance business" and "same grouping of companies" vary among jurisdictions. In Singapore, according to section 6 of the Companies Act, the definition of "same grouping of companies" includes subsidiary companies (i.e. with a controlling stake of more than 50%) and the concept encompasses corporations related to each other. In Bermuda, in addition to subsidiary companies with controlling stake of not less than 50%, the "same grouping of companies" includes financial relationships among companies.

22. As regards "captive insurance business", the Administration has pointed out that in Singapore, while business of a captive insurer should deal principally with risks of its related corporations, 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). Bermuda allows a captive insurer to be wholly owned by two or more unrelated persons which intends to carry on

³ Generally, the insurance industry takes that insurance also includes reinsurance.

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 a maximum of 20% of business not related to their group. In Labuan Island (Malaysia), a captive insurer may underwrite business risks of their own group, or third party risks, subject to Labuan Financial Services Authority's approval.

23. The Bills Committee notes the Administration's views that the 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 under the proposed concessionary tax regime for captive insurers in Hong Kong are no less stringent than those in other jurisdictions.

The need for a definition of "offshore risks"

24. The Bills Committee has considered the need to provide a definition of "offshore risks" in the Bill to facilitate the calculation of a captive insurer's assessable profits that are derived from the business of insurance of offshore risks and avoid possible abuse of the proposed tax concession by the captive insurer.

25. The Administration has responded that "offshore risks" are insured risks located outside Hong Kong. Whether a risk is located outside Hong Kong is a question of fact to be decided on a case by case basis. Any artificial step to alter the location of a risk is unlikely to succeed in the presence of the anti-avoidance provisions under IRO, in particular, sections 61 and 61A. The Administration has informed the Bills Committee that 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 purposes. Moreover, "offshore risks" is already a concept used in granting the existing profits tax concession for reinsurers' business of offshore risks. The Inland Revenue Department ("IRD") has not encountered any problem in the assessment of profits tax on "premiums from reinsurance of offshore risks" and is not aware of any tax avoidance cases taking advantage of the scope of "offshore risks" in this area. Furthermore, since offshore risks are normally related to offshore profits not subject to Hong Kong taxation, the Administration is of the view that tax abuses through the concessionary regime are unlikely to arise. IRD will monitor the situation and review the need to provide a definition of "offshore risks" in light of operation of the concessionary regime.

Regulatory regime for captive insurers

26. Given Hong Kong's status as a reputed international financial and business centre, the Bills Committee has stressed the importance for the Administration to maintain a robust regulatory regime over captive insurers to

ensure proper monitoring of their businesses and market risks, including putting in place measures to mitigate risks arising from insolvency of captive insurers.

27. The Administration has advised that captive insurers authorized under ICO are subject to the prudential supervision of IA. The major requirements include minimum capital and solvency margin, fitness and properness of directors and controllers, adequacy of reinsurance arrangements, submission of financial statements and business returns, and compliance with requirements in IA's guidance notes. IA monitors insurers' compliance with various requirements on an on-going basis through examining their financial statements and returns; analyzing critically their solvency position and risk management aspects, with due emphasis on the capital adequacy, quality of assets, reserving position and reinsurance arrangements; and conducting regular on-site inspections to monitor different areas of the insurer's operation. If there are any concerns in respect of a captive insurer, IA may, depending on the nature and level of concern, require the insurer to take remedial actions or exercise powers of intervention, including setting a limit on business volume or requiring a captive insurer to cease writing new business etc. In special circumstances, IA may even appoint a Manager to manage the affairs, business and property of an insurer including captive insurer. The Administration further advises that while a captive insurer underwrites exclusively the risk of its parent or group companies or their associated companies, it cannot write statutory lines of business (e.g. employees' compensation insurance, motor third party insurance) which involve the general public. Hence, the Bills Committee notes that insolvency of a captive insurer would create relatively lower systematic risks to the insurance market.

Deduction ceiling for contributions to recognized retirement schemes

The maximum relevant income level

28. The Bills Committee supports the proposal to raise the deduction ceiling in the assessment of salaries tax, tax under personal assessment and profits tax for contributions made by employees or SEPs to recognized retirement schemes. Members of the Bills Committee note that the amendments to IRO in this respect are technical in nature which are consequential to the commencement of the Mandatory Provident Fund Schemes Ordinance (Amendment of Schedule 3) Notice 2013 on 1 June 2014.

Drafting issue

29. Clause 9 of the Bill proposes to add a new Schedule 30 to IRO to provide for the transitional arrangements relating to the holding over of payment of provisional salaries tax and provisional profits tax, on the ground of the taxpayer's entitlement to the increase in the maximum amount of allowable deduction for contributions to recognized retirement schemes, for the years of

assessment 2014/15 and 2015/16. The Bills Committee notes that the usage of the phrases "[t]he ground is that..." (in the English text) and "有關理由是" (in the Chinese text) in the beginning of sections 2(2), 2(4), 4(2) and 4(4) of the proposed Schedule 30 may not convey a very clear meaning when the particular subsections are read alone, and the drafting of the provisions is different from that of similar provisions in other parts of IRO (e.g. existing section 3(4) of Schedule 25).

30. The Administration has responded that the Department of Justice has been adopting a plain language initiative in drafting in order to enhance simplicity and conciseness of law. This initiative includes avoiding unnecessary cross-referencing, which may be done by way of a narrative style of drafting. This drafting style is adopted for sections 2 and 4 of the proposed new Schedule 30 to 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. As such, it is considered 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.

Committee Stage amendments

31. The Bills Committee and the Administration will not propose Committee Stage amendments to the Bill.

Resumption of Second Reading debate

32. The Bills Committee supports the resumption of the Second Reading debate on the Bill at the Council meeting of 19 March 2014.

Consultation with the House Committee

33. The Bills Committee reported its deliberations to the House Committee on 28 February 2014.

Bills Committee on Inland Revenue (Amendment) (No. 3) Bill 2013

Membership list

Chairman Hon WONG Ting-kwong, SBS, JP

Members Hon James TO Kun-sun
Hon CHAN Kam-lam, SBS, JP
Hon Andrew LEUNG Kwan-yuen, GBS, JP
Hon Starry LEE Wai-king, JP
Hon CHAN Kin-por, BBS, JP
Hon Alan LEONG Kah-kit, SC
Hon Charles Peter MOK
Hon Kenneth LEUNG
Hon SIN Chung-kai, SBS, JP

(Total : 10 members)

Clerk Ms Connie SZETO

Legal Adviser Mr Timothy TSO

Concessions currently granted by the Government to captive insurance companies and comparison with non-life insurance companies on regulatory requirements

Item	Captive Insurer	Non-life Insurance Company
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 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

(Source: Extract from the Administration's paper (LC paper No. CB(1)905/13-14(02)).