

立法會
Legislative Council

LC Paper No. CB(1)770/14-15(02)

Ref : CB1/BC/5/14

Bills Committee on Inland Revenue (Amendment) Bill 2015

Background brief

Purpose

1. This paper provides background information on the Inland Revenue (Amendment) Bill 2015, and summarizes the major views and concerns expressed by Members when related issues were discussed by the relevant committees of the Legislative Council ("LegCo") since the 2012-2013 legislative session.

Background

Current tax exemption applicable to offshore funds

2. To reinforce the status of Hong Kong as an international financial centre and enhance its competitiveness, as well as attract more new offshore funds to Hong Kong and encourage existing offshore funds to continue to invest in Hong Kong, the Government proposed in the 2003-2004 Budget to exempt offshore funds from profits tax. After enactment of the Revenue (Profits Tax Exemption for Offshore Funds) Ordinance 2006¹, non-resident entities are exempt from tax for profits derived from "specified transactions" carried out through or arranged by a "specified person" and "transactions incidental to the carrying out of the specified transactions".

3. According to the Administration, the scope of "specified transactions" covers those transactions an offshore fund would typically perform in Hong Kong, including transactions in securities, futures contracts, foreign exchange contracts, foreign currencies, exchange-traded commodities and transactions

¹ The Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005 was introduced into LegCo on 6 July 2005. The report of the relevant bills committee is hyperlinked in the Appendix. The Bill was passed at the LegCo meeting of 1 March 2006 and enacted as the Revenue (Profits Tax Exemption for Offshore Funds) Ordinance 2006.

consisting in making deposits otherwise than by way of a money-lending business. To qualify for tax exemption, the "specified transactions" must be carried out by "specified persons", which include corporations and authorized financial institutions licensed or registered under the Securities and Futures Ordinance (Cap. 571) ("SFO") to carry out such transactions.

4. The Administration has pointed out that the current definition of "securities" does not generally include securities of a private company. In other words, offshore private equity funds that make use of the services of "specified persons" to derive profits from transactions in securities of private companies could be subject to Hong Kong profits tax. Besides, private equity funds may not necessarily be managed by corporations licensed by the Securities and Futures Commission ("SFC") under SFO.

Extending profits tax exemption for offshore funds to private equity funds

5. The Financial Secretary proposed in the 2013-2014 Budget to extend the profits tax exemption for offshore funds to include transactions in private companies which are incorporated or registered outside Hong Kong and do not hold any Hong Kong properties nor carry out any business in Hong Kong.

6. According to the Administration, providing clear tax exemption to transactions conducted by offshore funds in respect of eligible overseas portfolio companies will help attract more private equity fund managers to set up or expand their business in Hong Kong, and hire local asset management, investment and advisory services, which will be conducive to the further development of the local asset management industry. This will in turn drive demand for other relevant professional services, such as business consulting, tax, accounting and legal services.

The Inland Revenue (Amendment) Bill 2015

7. The Inland Revenue (Amendment) Bill 2015 ("the Bill") was published in the Gazette on 20 March 2015 and received its First Reading at the LegCo meeting of 25 March 2015. The Bill seeks to amend the Inland Revenue Ordinance (Cap. 112) ("IRO") to extend the profits tax exemption for offshore funds to private equity funds. The Bill, if enacted, will come into operation on the day on which it is published in the Gazette. The major proposals in the Bill are highlighted in paragraphs 8 to 11 below.

Extending tax exemption to offshore private equity funds

8. The definition of "securities" will be amended such that a transaction in securities in an eligible private company (i.e. portfolio company) will not be

excluded from a "specified transaction". To qualify for tax exemption, a portfolio company should be a private company incorporated outside Hong Kong. This aims to prevent abuse by local companies by simply converting their taxable profits to non-taxable income via an offshore fund structure. It is also required that the portfolio company, at all times within the three years before a transaction in securities in the portfolio company:

- (a) did not carry on any business through or from a permanent establishment in Hong Kong²;
- (b) falls within either of the following descriptions—
 - (i) it did not hold (whether directly or indirectly) share capital (however described) in one or more private companies carrying on any business through or from a permanent establishment in Hong Kong;
 - (ii) it held such share capital but the aggregate value of the holding of the capital is equivalent to not more than 10% of the value of its own assets; and
- (c) falls within either of the following descriptions—
 - (i) it neither held immovable property in Hong Kong, nor held (whether directly or indirectly) share capital (however described) in one or more private companies with direct or indirect holding of immovable property in Hong Kong³;
 - (ii) it held such immovable property or share capital (or both), but the aggregate value of the holding of the property and capital is equivalent to not more than 10% of the value of its own assets.

Allowing offshore qualifying private equity funds to enjoy tax exemption

9. To allow offshore private equity funds which are not managed by SFC licensees to also enjoy tax exemption, the existing exemption provisions will be amended such that an offshore private equity fund carrying out a "specified

² The offshore portfolio company may have some insignificant business activities in Hong Kong without giving rise to significant profits tax liability under IRO. The Bill therefore allows that if the place of business is for carrying on business activities of a purely preparatory or auxiliary character, such a place will not be considered as a permanent establishment.

³ Subject to a de minimis requirement, a portfolio company eligible for tax exemption should not hold any immovable property in Hong Kong to prevent local entities converting gains from investments in real estate to non-taxable income via an offshore fund structure.

transaction" could be eligible for tax exemption in respect of profits from that transaction if either of the following conditions is satisfied:

- (a) the specified transaction has been carried out through or arranged by a specified person;
- (b) the offshore private equity fund conducting the specified transaction is a "qualifying fund".

10. In order to be a "qualifying fund" and hence be eligible for tax exemption, the following conditions must be met:

- (a) at all times after the final closing of sale of interests –
 - (i) the number of investors exceeds four; and
 - (ii) the capital commitments made by investors exceed 90% of the aggregate capital commitments; and
- (b) the portion of the net proceeds arising out of the transactions of the fund to be received by the originator and the originator's associates, after deducting the portion attributable to their capital contributions (which is proportionate to that attributable to the investors' capital contributions), is agreed under an agreement governing the operation of the fund to be an amount not exceeding 30% of the net proceeds.

Allowing exemption from payment of tax for Special Purpose Vehicles

11. Private equity funds may use multi-level holding structures to accommodate preferences of fund investors. For example, private equity funds generally set up one or multiple-tier special purpose vehicles ("SPVs") to hold their portfolio companies. As such, it is proposed under the Bill to:

- (a) amend the definition of "securities" such that a transaction in securities in an SPV⁴ will not be excluded from the definition of a "specified transaction", so that offshore private equity fund will be exempt from tax in respect of profits derived from the transaction in the securities in an eligible portfolio company through disposal of securities in an SPV; and

⁴ Under the proposal, the SPV can be a corporation, partnership, trustee of a trust estate or any other entity incorporated, registered or appointed in or outside Hong Kong. It can be wholly or partially owned by a non-resident person and should be established solely for the purpose of holding, directly or indirectly, and administering one or more eligible portfolio companies.

- (b) add an express provision to give exemption from the payment of tax to an SPV in respect of profits derived from a transaction in securities in an interposed SPV or an eligible offshore portfolio company.

Members' views and concerns

12. The Administration briefed the Panel on Financial Affairs ("FA Panel") on the legislative proposal to extend the profits tax exemption for offshore funds to private equity funds at the meeting on 5 January 2015. Issues relating to the proposal were also discussed during the special meetings of the Finance Committee on 8 April 2013, 31 March 2014 and 30 March 2015 for the examination of the Estimates of Expenditure 2013-2014, 2014-2015 and 2015-2016. The ensuing paragraphs summarized the major views and concerns expressed by Members.

Qualifying conditions for offshore private equity funds and portfolio companies

13. Some Members questioned the policy considerations for imposing restrictive qualifying conditions on the portfolio companies. They urged the Administration to consider relaxing the conditions and waiving the conditions for certain types of portfolio company (e.g. high-technology and innovative companies), so as to attract these companies in using Hong Kong as a platform for corporate financing and asset management through private equity funds. There was also a suggestion to relax the requirement if the portfolio company's income derived from Hong Kong did not exceed a specified threshold (say 5% to 10%) of its total income.

14. The Administration explained that the current proposal was meant to extend profits tax exemption for offshore funds to include transactions in private companies which were incorporated or registered outside Hong Kong and did not hold any Hong Kong properties nor carry out any business in Hong Kong. The proposed qualifying conditions would serve as safe harbour within which the portfolio companies in question could be accepted as having met the policy objective.

15. As regards the suggestion of adopting an income threshold instead of an asset threshold for portfolio companies, the Administration advised that the proposed asset threshold (whereby the portfolio company should not directly or indirectly hold share capital in one or more private companies carrying on any business through or from any permanent establishment in Hong Kong, with the aggregate value of which capital exceeding 10% of the value of its own assets) reflected the views gathered from the fund industry during consultation, and had taken into account the operational needs of such companies (e.g. setting up

offices in Hong Kong for exhibition of business). For the term "permanent establishment", reference had been made to a relatively less stringent definition adopted by the Organization for Economic Cooperation and Development.

16. Members sought the reasons for an offshore private equity fund to have "five or more investors" (who were not associates of the originator of the fund) at all times after the final close of sale of interests as one of the qualifying conditions for tax exemption. The Administration explained that the proposed minimum number of investors had taken into account the typical characteristics of private equity funds including the number of investors on average. The purpose was to ensure that only bona fide private equity funds would be eligible for tax exemption and to prevent abuse or round-tripping by onshore private equity funds and other entities disguised as offshore funds.

Benefits of extending tax exemption to offshore private equity funds

17. While expressing support for the proposal to attract more funds to operate in Hong Kong and hence benefit the local economy at large, some Members stressed the need for the Administration to carefully assess the benefits and cost implications of the proposal on related trades, and suggested setting quantifiable targets for the proposal, such as the estimated growth in the total capital under management in private equity funds in Hong Kong, the estimated number and major markets of private equity funds to be attracted to operate in Hong Kong. On the other hand, some Members questioned the need to provide profits tax exemption to offshore private equity funds, since the total capital under management in private equity funds in Hong Kong could achieve substantial year-on-year increase even without the proposed tax exemption.

18. The Administration pointed out that a number of private equity fund managers had indicated interest to set up or expand their fund business in Hong Kong and use Hong Kong as a platform for managing assets. In particular, there was keen interest from the Mainland market players in raising private equity funds in Hong Kong for making investment in the Mainland. All along, there were calls from the fund industry for providing clear tax exemption to transactions conducted by offshore private equity funds in respect of eligible overseas portfolio companies, taking into account similar measures/proposals by other competitors (e.g. Singapore) in the region. The Administration therefore considered it both necessary and worthwhile to strengthen the measures in Hong Kong with a view to expanding its fund market and enhancing competitiveness amidst regional competition.

19. The Administration also pointed out that, while it would be difficult to quantify the targets or benefits, the current proposal was expected to attract more private equity fund managers to hire local asset management, investment and advisory services which would be conducive to further development of

Hong Kong's asset management industry. This would in turn drive demand for other relevant professional services, such as accounting and legal services. The objective of the proposal was to develop Hong Kong as an asset management hub which was not confined to a particular market or specific location of investment by the private equity funds.

20. On Members' concern about the estimated revenue forgone as a result of the proposal, the Administration said that reduction in tax revenue arising from the proposal was expected to be minimal since profits tax exemption was already applicable to offshore funds at present. Given that the current proposal was expected to attract more private equity fund managers to operate business in Hong Kong, the Administration considered that the potential increase in tax revenue and other economic benefits brought by the associated business activities would far outweigh the reduction in revenue from profits tax.

21. There was a view that the proposed tax exemption to private equity funds would only serve to facilitate the originators or managers of such funds rather than bringing benefits to investors concerned. The Administration pointed out that there was an increasing trend of professional or high-end investors allocating their assets in private equity funds. Investors of private equity funds might benefit directly or indirectly from the proposal in terms of potential increase in investment returns from the funds as a result of profits tax exemption.

Development of the asset management industry and risk management

22. As taxation might not be a decisive factor in attracting foreign investments and more funds to domicile in Hong Kong, some Members enquired about the Administration's overall strategy, and plans and measures to promote Hong Kong's fund and asset management business.

23. The Administration advised that it had been adopting multi-pronged strategies to promote Hong Kong's fund and asset management business. For instance, it was proposed in the 2013-2014 Budget to introduce an open-ended investment company structure in Hong Kong to expand Hong Kong's legal structure for investment fund vehicles. Moreover, SFC and the relevant Mainland authorities had reached general consensus on the framework of the mutual recognition of fund arrangement. The Government and regulators were also taking forward initiatives to ensure an adequate supply of professionals to support the private wealth management industry. In addition, certain specified investment funds (including unit trusts, mutual funds and similar investment schemes authorized under SFO or where the Commissioner of Inland Revenue was satisfied that they were bona fide widely held investment schemes which complied with the requirements of a supervisory authority within an acceptable regime) were exempted from profits tax under IRO. On the feasibility of

extending profits tax exemption to onshore funds, the Administration explained that it would take time to consider the suggestion in detail as it would involve much broader considerations having regard to the diverse types of investment activities, fair arrangement for different sectors and issues of tax avoidance. The fund industry appreciated the issues involved and welcomed the current proposal to extend profits tax exemption for offshore funds to private equity funds as a first step.

24. Some Members expressed concern that a more favourable investment environment might give rise to more money laundering activities and flows of illicit funds, and urged the Administration to enhance risk management when attracting more funds to domicile in Hong Kong. The Administration stressed that it attached great importance to financial safety and, in joint efforts with the relevant regulators, would continue to monitor closely the situation of local markets, and review the risk management requirements from time to time. The Administration would also consider how to prevent abuse of the proposed tax extension arrangement for tax avoidance.

Latest development

25. At the House Committee meeting on 10 April 2015, Members agreed to form a Bills Committee to study the Bill.

Relevant papers

26. A list of relevant papers is in the **Appendix**.

List of relevant papers

Date	Event	Paper/Minutes of meeting
4 April 2005	Meeting of the Panel on Financial Affairs ("FA Panel")	Administration's paper on "Legislative Proposal to Provide Profits Tax Exemption to Offshore Funds" (LC Paper No. CB(1)1160/04-05(03)) Minutes (paragraphs 9 to 36) (LC Paper No. CB(1)1677/04-05)
6 July 2005	Introduction of the Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005 into the Legislative Council	The Bill Legislative Council Brief (File Ref: FIN CR3/7/2201/02) Legal Service Division report (LC Paper No. LS91/04-05)
1 March 2006	Resumption of debate on Second Reading of the Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005	Report of the Bills Committee (LC Paper No. CB(1)906/05-06) Hansard (page 124-148)
27 February 2013	Financial Secretary presented the 2013-2014 Budget	Speech by the Financial Secretary (Paragraph 45)
8 April 2013	Special meeting of Finance Committee for examination of Estimates of Expenditure 2013-2014	Written questions raised by Members and Administration's replies (Reply serial number: FSTB(FS)038, 052, 084, 085, 087, 103, 123 and 134)
31 March 2014	Special meeting of Finance Committee for examination of	Written questions raised by Members and Administration's replies (Reply serial number: FSTB(FS)043,

Date	Event	Paper/Minutes of meeting
	Estimates of Expenditure 2014-2015	096 and 104)
5 January 2015	Meeting of FA Panel	Administration's paper (LC Paper No. CB(1)385/14-15(02)) Minutes (paragraphs 31 to 46) (LC Paper No. CB(1)697/14-15)
25 March 2015	Introduction of the Inland Revenue (Amendment) Bill 2015 into the Legislative Council	The Bill Legislative Council Brief (File Ref: ASST/3/1/5C(2014)) Legal Service Division report (LC Paper No. LS56/14-15)
30 March 2015	Special meeting of Finance Committee for examination of Estimates of Expenditure 2015-2016	Written questions raised by Members and Administration's replies (Reply serial number: FSTB(FS)034)