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Paper for the House Committee meeting on 19 June 2015

**Report of the Bills Committee
on Inland Revenue (Amendment) Bill 2015**

Purpose

This paper reports on the deliberations of the Bills Committee on Inland Revenue (Amendment) Bill 2015 ("the Bills Committee").

Background

2. The Inland Revenue Ordinance ("IRO") (Cap. 112) was amended in 2006 to exempt offshore funds from profits tax. Under section 20AC of the IRO, non-resident entities (which can be individuals, partnerships, trustees of trust estates or corporations) are exempt from tax for profits derived from "specified transactions" carried out in Hong Kong which cover transactions in securities, future contracts, foreign exchange contracts, foreign currencies, exchange-traded commodities and transactions consisting in the making of a deposit other than by way of a money-lending business. 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 Part V of the Securities and Futures Ordinance ("SFO") (Cap. 571). Transactions that are incidental to carrying out the "specified transactions" are also exempt from profits tax.

3. The current definition of "securities" as one of the "specified transactions" in Schedule 16 to the IRO does not include shares, debentures and the related rights, options or interests of a private company. In consequence, any transaction in the securities of a private company from which an offshore fund made profits could be subject to profits tax in Hong

Kong. Also, offshore private equity funds will not qualify for profits tax exemption if they are not managed by corporations or authorized financial institutions licensed or registered by the Securities and Futures Commission under the SFO.

4. According to the Administration, the Inland Revenue (Amendment) Bill 2015 ("the Bill") seeks to amend the IRO to extend the profits tax exemption for non-resident persons to include transactions in securities of, or issued by, eligible private companies (i.e. portfolio companies) incorporated outside Hong Kong; to exempt non-resident persons that are qualifying funds from profits tax; to exempt special purpose vehicles ("SPVs") from the payment of profits tax; and to provide for related matters.

5. By providing a clear tax exemption to transactions conducted by offshore private equity funds in respect of eligible overseas portfolio companies, the Administration hopes to attract more offshore private equity fund managers to set up or expand their business in Hong Kong, thereby generating demand for local asset management, investment and advisory services and other relevant professional services.

6. To give effect to the proposal, the Administration introduced the Bill into the Legislative Council on 25 March 2015.

The Bill

7. The main provisions of the Bill are as follows –

(a) Clause 4 amends section 20AC of the IRO to:

- (i) exempt a non-resident person that is a qualifying fund from profits tax in respect of assessable profits of the person arising from certain transactions;
- (ii) provide that section 20AC does not apply to an SPV; and
- (iii) provide for the application of the amended section 20AC.

(b) Clause 5 adds a new section 20ACA to the IRO. The new section exempts an SPV, which may be a resident person or a

non-resident person, from the payment of tax in respect of assessable profits arising from certain transactions concerning an interposed SPV, or an excepted private company, as defined by that section.

- (c) Clause 8 adds a new section 20AF to the IRO. The new section provides that in certain circumstances, the assessable profits of an SPV that is held by a non-resident person and exempt from the payment of tax under the new section 20ACA, are to be regarded as the assessable profits of a resident person.
- (d) Clause 11 amends Schedule 16 to the IRO. The definition of securities in section 1 of Part 2 of that Schedule is amended so that interests such as shares and debentures of, or issued by, SPVs and excepted private companies fall within the definition.

The Bills Committee

8. At the House Committee meeting on 10 April 2015, members agreed to form a Bills Committee to study the Bill. The membership list of the Bills Committee is in **Appendix I**. Under the chairmanship of Hon Christopher CHEUNG Wah-fung, the Bills Committee has held two meetings to discuss with the Administration and received views from the public at one of the meetings. A list of the deputations which have given views to the Bills Committee is in **Appendix II**.

Deliberations of the Bills Committee

9. The Bills Committee notes that the current profits tax exemption regime for offshore funds does not cover transactions in securities of private companies and that this has resulted in private equity fund managers taking onerous procedures to mitigate the potential exposure of their offshore funds to Hong Kong profits tax. This has put Hong Kong in a relatively disadvantaged position for attracting private equity fund managers to Hong Kong.¹

¹ Research Paper No. 6 published by the Financial Services Development Council in November 2013 cited in the Administration's response to the Bills Committee issued vide CB(1)849/14-15(02).

10. In general, the Bills Committee has raised no objection to the Administration's proposal to provide a clear tax exemption to transactions conducted by offshore private equity funds in respect of eligible overseas portfolio companies. The Chairman and members including Ir Dr LO Wai-kyok and Mr NG Leung-sing have expressed support for the proposed exemption as they consider that it could help expand Hong Kong's fund market and enhance its competitiveness amidst regional competition. In the course of scrutinizing the proposed extension of exemption, the Bills Committee has analyzed the cost and benefits to Hong Kong that it may bring about, studied whether it can also be extended to local companies, and clarified with the Administration the interpretation of certain deeming provisions in the Bill.

Cost and benefits of the proposed tax exemption

11. Regarding the justification for the proposed profits tax exemption for offshore private equity funds, Mr Alan LEONG has sought elaboration on its financial and economic implications to Hong Kong in terms of the cost, such as tax revenue forgone, and benefits, whether actual or anticipated, that it may bring to Hong Kong. Specifically, Ir Dr LO Wai-kyok has enquired about the estimated number of private equity funds which can be attracted to be managed in Hong Kong, and the estimated growth in the total capital under management by private equity funds in Hong Kong, etc. after the implementation of the proposed profits tax exemption for offshore private equity funds.

12. Miss CHAN Yuen-han has expressed concern about the possibility of the proposed profits tax exemption being abused and giving rise to tax avoidance. Regarding the scope of the types of companies targeted by the proposed tax exemption, Mr Charles MOK is concerned that it would benefit offshore portfolio companies at the expense of local companies. To obtain a baseline for evaluating such impact in future, he has sought information about the present ratio of local and overseas portfolio companies that private equity funds in Hong Kong have invested in.

13. On these concerns of members, the Administration has advised that by providing clear tax exemption to transactions conducted by offshore private equity funds in respect of eligible private companies outside Hong Kong, it hopes to provide the private equity fund industry with the tax certainty that the profits derived from transactions in securities of private companies outside Hong Kong will not be subject to tax liability in Hong Kong, so as to 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. Income received by local fund managers and other service providers will continue to be subject to Hong Kong tax.

14. The Administration also has advised that offshore private equity funds normally use the asset management and professional services in other jurisdictions so as to minimize their exposure to Hong Kong tax liability. Since the inception of offshore fund tax exemption regime in 2006, no profits tax assessment has been raised to assess profits derived by offshore private equity funds from the disposal of private companies outside Hong Kong. On this basis, the Administration expects that the cost of the proposal to Hong Kong in the form of tax revenue forgone should be minimal.

15. On the other hand, according to the Administration, the proposal will help attract more offshore private equity fund managers to set up or expand their business in Hong Kong, thereby generating demand for local asset management, investment and advisory services, as well as other relevant professional services. This would help foster the further development of the financial services sector in Hong Kong and drive demand for other relevant professional services, such as business consulting, tax, accounting and legal services. Whilst the actual benefits may not be quantifiable at this stage, it can be of reference that since the implementation of the profits tax exemption for offshore funds in 2006, Hong Kong's combined fund management business has grown by 2.6 times from \$6,154 billion as at the end of 2006 to \$16,007 billion as at the end of 2013.

16. On the information sought by members, the Administration has advised that in terms of the size of capital under management by private equity funds, Hong Kong ranked second, after Mainland China, in Asia, accounting for 21% of the total capital under management as at end 2014. In respect of the total private equity investments in the Asia Pacific Region made by private equity firms worldwide, the proportion of investments in portfolio companies in Hong Kong (in terms of the deal amount) is 2.57% in 2012, 1.88% in 2013 and 9.77% in 2014.

17. On members' concern about the risk of abuse by companies or individuals seeking to avoid tax, the Administration has advised that the proposed extension of the profits tax exemption aims to allow offshore private equity funds to enjoy the same exemption under the IRO as those currently available to other offshore funds. Under the proposal, qualifying conditions on the portfolio companies and qualifying funds are imposed to

ensure that only bona fide offshore private equity funds will be eligible for the proposed tax exemption.

18. The Bills Committee notes that Hong Kong's competitors in the region, such as Singapore, offer similar tax exemption to private equity funds. Ir Dr LO Wai-kiwok and Mr NG Leung-sing has sought information on measures in Singapore in respect of profits tax exemption for offshore private equity funds. In this connection, the Administration has advised that Singapore has introduced an offshore fund exemption scheme which gives offshore funds exemption from tax on income from designated investments including most types of investment like stocks and shares of any company, other than an unlisted company that is in the business of trading or holding immovable property locally. The proposed extension of the profits tax exemption in Hong Kong for offshore funds to private equity funds is comparable.

Feasibility of extending the exemption to local companies

19. The Bills Committee notes that it is the policy intent of the Bill to extend the profits tax exemption for offshore funds to include transactions in eligible private companies which do not hold any Hong Kong properties nor carry out any business in Hong Kong. Specifically, under the new section 20ACA, to qualify for tax exemption, a portfolio company should be a private company incorporated outside Hong Kong, and at all times within the three years before a transaction in securities in the private company is carried out, it did not –

- (i) carry on any business through or from a permanent establishment in Hong Kong;
- (ii) hold share capital in one or more private companies carrying on any business through or from a permanent establishment in Hong Kong, where the aggregate value of the capital exceeded 10% of the value of its own assets; and
- (iii) hold immovable property in Hong Kong or share capital in one or more private companies with direct or indirect holding of immovable property in Hong Kong, where the aggregate value of the holding of the property and capital exceeded 10% of the value of its own assets.

20. Mr Charles MOK considers that these qualifying conditions for the proposed profits tax exemption do not appear to be able to attract more private equity funds to invest in local start-ups and in particular, promote the development of technology start-ups in Hong Kong. He has suggested that the profits tax exemption be extended to transactions in securities in private companies incorporated in Hong Kong. Similarly, Mr Kenneth LEUNG holds the view that the Administration should consider relaxing or waiving the above-mentioned qualifying conditions for the proposed profits tax exemption in respect of certain types of local portfolio companies, for example, companies and start-ups related to the environmental, clean energy or high-technology businesses. In Mr LEUNG's view, this can attract these companies to use Hong Kong as a platform for corporate financing and asset management through private equity funds. In particular, Mr LEUNG has pointed out the fund industry's suggestion of extending profits tax exemption to offshore private equity funds for a certain proportion of their investments in local companies and has enquired why the Administration has not taken such suggestion on board.

21. The Administration has advised that in formulating the proposal, it has taken into account the common practices of private equity funds and views of the industry, and that the proposed qualifying conditions already provide certain flexibility so that the portfolio companies may carry on business activities of a purely preparatory or auxiliary character, and that they may hold immovable property the value of which should not exceed 10% of the value of the total assets of the private company.

22. The Administration stresses that any further relaxation of the conditions may create loopholes for tax avoidance as it would be made easier for local companies to simply convert their taxable profits to non-taxable income via an offshore fund structure. This will have implications on Government's tax revenue. Regarding the proposal to relax or waive the conditions for certain types of portfolio companies (e.g. high-technology and innovative companies), this would have wide-ranging read-across implications and need to be considered carefully from the fairness perspective.

23. On the suggested extension of profits tax exemption to offshore private equity funds for a certain proportion of their investments in local companies, the Administration has advised that in the IRO, the definition of "non-resident persons" include individuals, corporations, partnerships and trustees of trust estates. In view of the various forms of entities concerned, it will be difficult to devise an exemption regime which would address the

fund industry's request while effectively preventing abuse of the exemption for tax avoidance.

24. On this point, Mr Kenneth LEUNG considers it unlikely that granting tax exemption to offshore private equity funds investing in local private companies would increase the possibility of onshore funds seeking to redomicile to other jurisdictions, thereby causing implications on Government's tax revenue. He has appealed to the Administration to consider, in the next stage of its work, extending the profits tax exemption to offshore private equity funds which invest passively in local start-ups, so as to promote the development of start-ups in Hong Kong, and help diversify Hong Kong's economic base.

25. The Administration reiterates that the current proposal of tax exemption has struck a balance between addressing the calls from the fund industry for providing clear tax exemption to transactions conducted by offshore private equity funds in respect of eligible private companies outside Hong Kong and preventing possible abuse of the exemption. Extending profits tax exemption to investments in local private companies would require much broader and in-depth policy considerations. In short, the Administration sees the current proposal a first step of a more far-reaching change, if considered desirable in future and has assured members of its commitment to enhancing the support and ecosystem for local start-ups and technological enterprises to enable local industries to diversify.

Deeming provisions applicable to offshore private equity funds
(*Clause 8 – new section 20AF of the IRO*)

26. Upon scrutinizing the Bill, the Bills Committee notes that to prevent abuse or round-tripping by onshore or resident entities disguised as offshore funds, the existing deeming provisions in the IRO would equally apply to offshore private equity funds. Such deeming provisions are in the new section 20AF which provides that when a resident person (alone or jointly with his associates) holds a beneficial interest of 30% or more in a tax-exempt private equity fund, and the fund has a beneficial interest in an SPV that is exempt from the payment of tax in respect of its assessable profits from certain transactions, the resident person will be deemed to have derived assessable profits in respect of profits earned by the SPV.

27. It is also noted that the new section 20AF(7) will serve as safe harbour within which the deeming provisions will not apply if the Commissioner of Inland Revenue is satisfied that beneficial interests in the

offshore private equity fund was bona fide widely held. On how the requirement of "bona fide widely held" in the section could be satisfied, Mr Kenneth LEUNG has sought elaboration.

28. According to the Administration, the term "bona fide widely held" has been adopted in sections 20AE(8) and 26A(1A) of the IRO without a statutory definition. In the Departmental Interpretation and Practice Notes No. 20 and 43, the Inland Revenue Department ("IRD") has consistently interpreted the term "bona fide widely held" as follows –

- (i) during the year of assessment in question, at no time did fewer than 50 persons (or have the right to become the holders of) held all of the units or shares in the offshore fund; and
- (ii) at no time during the year did fewer than 21 persons held (or have the right to become the holders of) units or shares that entitled the holders, directly or indirectly, to 75%, or more, of the income or property of the non-resident fund.

29. As for the reason for using the term "bona fide widely held" in the IRO, the Administration has explained that a resident person holding a small interest in an offshore fund may have difficulty in ascertaining the weighting of his interests in the fund when he reports deemed profits to IRD. The Administration has further advised that in the case where the above-mentioned benchmark figures (in paragraph 28 (i) and (ii)) are not met, IRD will accept in practice that the "bona fide widely held" requirement has been satisfied if it is clear from the constitutive documents of the non-resident fund and other relevant materials that it is established with a view to wide public participation and that genuine efforts have been made with the aim of achieving that objective, i.e. there is nothing to suggest that the non-resident fund is intended to be a closely held investment vehicle.

Legal and drafting issues

30. The Bills Committee has examined the Bill clause by clause and finds no difficulties relating to the legal and drafting aspects of the Bill. It has noted the drafting issues raised by the Legal Adviser to the Bills Committee² and the Administration's responses on those issues³.

² Issued vide LC Paper No. CB(1)770/14-15(03) and CB(1)849/14-15(03).

³ Issued vide LC Paper No. CB(1)770/14-15(04) and CB(1)849/14-15(04).

Committee Stage amendments

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

Resumption of Second Reading debate on the Bill

32. The Bills Committee supports the resumption of the Second Reading debate on the Bill.

Advice sought

33. Members are invited to note the deliberations of the Bills Committee.

Council Business Division 1
Legislative Council Secretariat
16 June 2015

Bills Committee on Inland Revenue (Amendment) Bill 2015

Membership List

Chairman Hon Christopher CHEUNG Wah-fung, SBS, JP

Members Hon CHAN Kam-lam, SBS, JP

Hon Abraham SHEK Lai-him, GBS, JP

Hon Andrew LEUNG Kwan-yuen, GBS, JP

Hon Starry LEE Wai-king, JP

Hon Alan LEONG Kah-kit, SC

Hon NG Leung-sing, SBS, JP

Hon Charles Peter MOK, JP

Hon CHAN Yuen-han, SBS, JP

Hon Kenneth LEUNG

Hon SIN Chung-kai, SBS, JP

Ir Dr Hon LO Wai-kwok, BBS, MH, JP

(Total : 12 members)

Clerk Mr Derek LO

Legal Adviser Ms Vanessa CHENG

Bills Committee on Inland Revenue (Amendment) Bill 2015

List of organizations that have given views to the Bills Committee

- * 1. Hong Kong Venture Capital and Private Equity Association
- 2. Joint Liaison Committee on Taxation
- 3. The Taxation Institute of Hong Kong

Note

- * denotes the organization the representative of which has attended a meeting of the Bills Committee