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14 March 2016

The Honourable Mr. Chan Kam-Lam
Chairman
Bills Committee on Securities and Futures (Amendment) Bill 2016
Legislative Council Secretariat
Hong Kong

Dear Mr. Chan,

Submission on the Securities and Futures (Amendment) Bill 2016

We write to make submissions on the above-mentioned Bill dealing with the introduction of open-ended fund companies (OFCs) in Hong Kong.

Because the JLCT's mission is focused on tax, we restrict our comments to tax and stamp duty issues only. Our submission is therefore brief. We also note that the Administration is proposing the introduction of a broader range of tax exemptions for OFCs as a "phase 2" exercise. We do not comment on those possible changes, but restrict our comments to what is currently contained in the Bill.

We have no comment with respect to the proposed amendments in the Bill to the Inland Revenue Ordinance (IRO) and the Stamp Duty Ordinance (SDO), insofar as they go. However, we are concerned that the amendments in the IRO do not go far enough in achieving the necessary demarcation between the sub-funds of an OFC for profits tax purposes.

To explain this further, an OFC is a single corporation, and therefore constitutes a single taxable "person" for the purposes of s.2(1) of the IRO. The sub-funds are not separate legal entities and are therefore not "persons" for the purposes of the IRO. This means that they cannot be separate taxable entities. The consequences of this are as follows.

- 1 *Issue of tax assessments.* A profits tax assessment can be raised only against the OFC as a whole, and not for each sub-fund. This is because a sub-fund is not a "person" for the purposes of the IRO. An assessment can be issued only in respect of a "person": see s.59(1), IRO.
- 2 *Consolidation of profits.* Furthermore, any profits tax assessment would need to be issued to the OFC with respect to *consolidated* taxable profits of the OFC as a whole, including all its sub-funds. There is no ability to issue separate tax assessments for each sub-fund.

Again, this is because a sub-fund is not a “person” for the purposes of the IRO. An assessment can be issued only in respect of a “person”: s.59(1), IRO.

- 3 *Filing of profits tax returns.* An OFC would be permitted to file a single profits tax return only in respect of all of the consolidated profits and losses of all of its sub-funds. Individual sub-funds cannot file separate returns. This is because a return must be filed only by a “person” as defined in the IRO: s.51(1), IRO.
- 4 *Utilization of tax losses.* The profits and losses of each sub-fund cannot be quarantined for profits tax purposes within each sub-fund. Thus, a profit-making sub-fund would be entitled to the benefit of the losses of a loss-making sub-fund. Losses cannot be carried-forward within a sub-fund alone. This is because losses made by a “person” as defined by the IRO (that is, the OFC as a whole) are available for deduction against all of the profits of that person: s.19, IRO.
- 5 *Liability to pay profits tax.* The liability to pay profits tax on the OFC’s consolidated taxable profits would arguably fall on the OFC as a whole, and not merely on the relevant sub-funds. Thus, if a sub-fund did not pay the tax due on its profits, the OFC as a whole (and hence the other sub-funds) would be liable to pay instead, because the tax liability is the liability of the OFC as a whole and not a liability of the relevant sub-fund. Admittedly, this point is arguable because proposed s.112S(2) states that any liability “attributable” to a sub-fund may only be discharged out of the assets of that sub-fund, but it would be clearer if this point were reflected in the IRO itself.
- 6 *Exemption for offshore funds.* A sub-fund by itself might seemingly qualify for the so-called offshore funds exemption contained in s.20AC of the IRO, but such exemption would be lost if the OFC *as a whole* does not meet the criteria for the exemption. This is because the exemption is available only if the “person” as defined in the IRO (that is, the OFC as a whole) meets the exemption criteria. The exemption would be lost, for example, if one of the sub-funds earns profits from non-specified transactions or conducts transactions through non-specified persons.
- 7 *Taxation of Hong Kong investors.* Where an OFC qualifies for tax exemption under the so-called offshore funds exemption under s.20AC, there would be an obligation under the anti-avoidance provision in s.20AE on any Hong Kong resident who owns 30% or more of the shares of the OFC to pay profits tax on its pro-rata share of the OFC’s profits. However, a person who owns more than 30% of a sub-fund alone would not fall within the scope of this anti-avoidance provision if it does not own 30% or more of the OFC as a whole. This is because the 30% threshold must be measured with respect to the “person” as defined in the IRO, that is, the OFC as a whole, and not just with respect to the relevant sub-fund.

You will note that these concerns all arise from the fact that the OFC as a whole is the taxable “person” for the purposes of the IRO. These concerns would not apply if each sub-fund were to be deemed to be a “person” for IRO purposes.

We understand that the IRD proposes to treat sub-funds separately for profits tax purposes, but we do not understand the legal basis for it doing so based on the current wording of the Bill. Without a firm legal underpinning for such a practice, disputes are likely to arise. We respectfully caution the Bills Committee that it is essential that the Bill contains the proper legal framework for the separate tax treatment of each sub-fund within an OFC structure.

The amendments to the SDO address this issue for stamp duty purposes by including a deeming provisions that will deem each sub-fund to be a separate person for stamp duty purposes: see proposed s.37C(3). We urge that a similar amendment be made to the IRO, to ensure that each sub-fund within

an OFC structure is treated as a separate person for profits tax purposes. Alternatively, the definition of "person" in s.2(1) of the IRO could be amended to include a sub-fund of a OFC.

We acknowledge from the FSTB's "concept paper" dated January 2016 that the Administration is considering introducing a further bill at some later stage that will extend a new profits tax exemption to OFCs that are resident in Hong Kong and whose securities are not marketed to the public (and which are therefore not authorised by the SFC). That is, of course, a separate exercise and will not impact on the position of OFCs that are resident outside Hong Kong or which are authorised by the SFC. In any event, the concept paper does not make any proposals in respect of the filing, assessment and tax loss issues we have described above.

We hope the above is helpful. Should you have any questions or require any clarification, please call me at [REDACTED].

Yours sincerely,

A handwritten signature in black ink, appearing to read "Michael Olesnick", with a long, sweeping horizontal stroke extending to the right.

Michael Olesnick,
Chairman,
For and on behalf of the
Joint Liaison Committee on Taxation