立法會
Legislative Council

LC Paper No. CB(1)1328/16-17(02)

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Bills Committee on Inland Revenue (Amendment) (No. 4) Bill 2017

Background brief

Purpose

This paper provides background information on the Inland Revenue (Amendment) (No. 4) Bill 2017 ("the Amendment Bill 2017"). It also gives a brief account of the views and concerns expressed by Members on the benefits of introducing the open-ended fund company ("OFC") structure in Hong Kong and profits tax treatment of OFCs since the 2013-2014 legislative session.

Background

Establishment of a legal framework for the open-ended fund company structure in Hong Kong

2. Currently, an open-ended investment fund may be established under the laws of Hong Kong in the form of a unit trust but not in corporate form due to various restrictions on capital reduction under the Companies Ordinance (Cap. 622) ("CO"). There are market calls for a more flexible choice of investment fund vehicle through introducing a new OFC structure in Hong Kong. This will allow investment funds to be set up in the form of a company, but with the flexibility to create and redeem shares for investors to trade the funds, which is currently not enjoyed by conventional companies.

3. To provide for the legal framework for the OFC structure in Hong Kong, the Securities and Futures (Amendment) Ordinance 2016 ("the Amendment Ordinance 2016") was enacted by the Legislative Council ("LegCo") in June 2016. The detailed operational and procedural matters of the OFC structure are to be set out in subsidiary legislation under the Securities and Futures Ordinance (Cap. 571) ("SFO") ("the OFC Rules") which are subject to

negative vetting by LegCo. The Amendment Ordinance 2016 will commence operation after the OFC Rules have been put in place.

Major characteristics of an open-ended fund company

Structure and key features

4. An OFC is an open-ended collective investment scheme, which is structured in corporate form with limited liability and variable share capital. Investment in OFC (as in the case of funds generally) is typically made by way of subscription and redemption of units/shares in the fund. The OFC structure and key operators proposed under the Amendment Ordinance 2016 are illustrated in **Appendix I**. An OFC has characteristics similar to a conventional limited company in that:

(a) it will have a legal personality;

(b) it will have a constitutive document, namely the instrument of incorporation; and

(c) it will be governed by a board of directors who are subject to fiduciary duties and the duty to exercise reasonable care, skill and diligence, and the liability of its shareholders will be limited to the amount unpaid on their shares in the company.

5. As OFC is an investment vehicle, it –

(a) will not be bound by restrictions on the reduction of share capital applicable to companies formed under CO, and instead will have the flexibility to vary its share capital in order to meet shareholder subscription and redemption requests;

(b) will not be bound by restrictions on distribution out of share capital applicable to companies formed under CO and instead, may distribute out of share capital subject to solvency and disclosure requirements; and

(c) will not be required to be licensed as a licensed corporation under SFO, but will have to be registered with the Securities and Futures Commission ("SFC"), and should delegate its investment management functions to an investment manager licensed by or registered with SFC who is appointed by the OFC board.

Establishment and regulation

6. To incorporate an OFC, the applicant should apply to SFC for registration prior to applying to the Registrar of Companies ("CR") for incorporation. Besides, OFCs will be required to register under the Business Registration Ordinance (Cap. 310). OFCs seeking to offer their shares to the public must also seek the authorization of SFC under SFO.

7. SFC is the primary regulator responsible for the registration and regulation of OFCs under SFO. It is empowered by SFO to make subsidiary legislation and publish a code or guideline to regulate and provide guidance on the incorporation, management, operation, and business of OFCs. In addition, CR is responsible for the incorporation and administration of statutory corporate filings of OFCs.

Profits tax treatment

8. Currently, profits tax exemption is given under the Inland Revenue Ordinance (Cap. 112) ("IRO") to public funds (no matter whether their central management and control is located in or outside Hong Kong) authorized by SFC. The same profits tax exemption will apply to publicly offered OFCs. At present, for privately offered funds, profits tax exemption is also provided under IRO if they are offshore funds (i.e. with their central management and control locates outside Hong Kong). So profits tax exemption will apply to offshore privately offered OFCs. Yet, onshore privately offered funds (i.e. with their central management and control locates in Hong Kong) are still subject to profits tax.

The Inland Revenue (Amendment) (No. 4) Bill 2017

9. The Amendment Bill 2017 was gazetted on 23 June 2017, and received its First Reading at the LegCo meeting of 28 June 2017. The Amendment Bill 2017 aims to extend profits tax exemption to onshore privately offered OFCs ("subject OFCs"). It is proposed that a subject OFC has to satisfy the following four conditions in order to qualify for profits tax exemption –

(a) the subject OFC must be a resident person with its central management and control exercised in Hong Kong;

(b) the subject OFC must be "non-closely held" ("NCH", as defined in the proposed new section 20AI);

(c) the subject OFC must invest in permissible asset classes specified by SFC; and

(d) transactions of the subject OFC must be carried out through or arranged by a qualified person.

10. Details of the main provisions of the Amendment Bill 2017 are set out in paragraph 15 of the LegCo Brief (File Ref: ASST/3/1/5/1C(2017)Pt.6 dated 21 June 2017), and paragraphs 6 to 13 of the Legal Service Division Report on the Amendment Bill 2017 (LC Paper No. LS91/16-17). Except for item 8 of the new Schedule 16A in relation to over-the-counter derivative products as defined in Part 1 of Schedule 1 to SFO[1], the Amendment Bill 2017, if passed, would come into operation on a day to be appointed for the commencement of the Amendment Ordinance 2016.

Concerns and views expressed by Members

11. Matters relating to the OFC regime in Hong Kong were discussed at the meetings of the Panel on Financial Affairs ("FA Panel") on 7 April 2014 and 16 March 2017, and the Bills Committee on the Securities and Futures (Amendment) Bill 2016. The major views and concerns expressed by Members at these meetings are summarized in the ensuing paragraphs.

<u>Benefits of introducing the open-ended fund company structure in Hong Kong</u>

12. Members noted that the fund industry was generally supportive of the introduction of the OFC structure in Hong Kong to provide an extra option for fund structure. The OFC structure would diversify Hong Kong's fund types, expand the fund distribution network and promote fund origination in Hong Kong to deepen and broaden Hong Kong's asset management industry. These would in turn drive demand for professional services and help strengthen Hong Kong's position as an international financial centre.

13. There was a suggestion that the Government should consider putting in place measures to facilitate or incentivize listing and trading of OFC shares on the stock exchange. SFC pointed out that so long as the Listing Rules and other applicable requirements were met, investment funds including OFCs could be listed on the stock exchange. The Government assured Members

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[1] Item 8 of the new Schedule 16A would come into operation on the day to be appointed for the commencement of section 53(8) of the Securities and Futures (Amendment) Ordinance 2014, which provides for a regulatory framework for the over-the-counter derivatives markets in Hong Kong.

that it would continue to take forward initiatives to support the development of the asset management industry, including the potential establishment of the exchange distribution platform for funds in Hong Kong.

Conditions for profits tax exemption

14. Noting that subject OFCs were required to meet the NCH condition for a further 24-month period after the first 24-month period, Members enquired how the Inland Revenue Department would monitor compliance with the proposed NCH condition.

15. The Government explained that the proposed 24-month-plus-24-month ownership requirement under the NCH condition had been formulated taking into account the industry's views that a reasonable period should be allowed for a subject OFC to meet the NCH condition since a fund would take some time to establish a track record and attract investors. The first 24-month period would start counting from the date the fund accepted its first investor. Further, to prevent a subject OFC from abusing the exemption from tax payment, it would be required to continue to meet the NCH condition for a further period of 24 months after the first 24-month start-up period. The second 24-month period aimed to prevent individuals or entities from taking advantage of the tax exemption in the first 24-month period by repeatedly opening and closing a subject OFC every 24 months. That said, there would be safe harbour rules allowing a subject OFC to seek tax exemption from the Commissioner of Inland Revenue if it failed to meet the NCH condition owing to certain circumstances, such as winding down of activities and investments and market fluctuations.

16. Given that the structure of funds varied, for instance, pension funds and sovereign wealth funds usually had a large fund size and a large number of investors, Members enquired if the Government would review the ownership requirement under the NCH condition in future, such as reducing the minimum number of investors in the subject OFC and relaxing the maximum 30% participation interest by the originator and the originator's associates in the OFC. Members also asked whether the Government would consider granting stamp duty exemption to OFCs.

17. The Government responded that the policy intent was to attract funds with a larger number of investors and a reasonably large fund size to domicile in Hong Kong. The Government would review the effectiveness of the proposal in attracting the domiciliation of OFCs in Hong Kong at an appropriate juncture in future, and, if necessary, might consider adjusting the NCH condition as the circumstances might warrant. On the issue of stamp

duty, the Government advised that OFCs would be subject to the same stamp duty arrangements as unit trusts. Like transfer of units in non-listed unit trust schemes, transferring shares of non-listed OFCs by way of allotment and redemption would not be subject to stamp duty.

Measures to prevent possible abuse of profits tax exemption

18. Members expressed concern that a small group of individuals might establish a company with an OFC structure to conduct securities transactions in order to avoid paying profits tax. They asked how the Government would tackle the possible abuse.

19. The Government said that in addition to the ownership requirement, a subject OFC should also meet the fund document requirement and terms and conditions requirement. Each of its investors would need to meet the participation interest requirements with respect to a minimum amount of investment made (i.e. $200 million for a qualifying investor and $20 million for a non-qualifying investor) and a maximum percentage shareholding allowed. Moreover, the investment management functions of a subject OFC must be carried out through or arranged by corporations or financial institutions licensed or registered under SFO. Similar to a conventional limited company, the subject OFC would need to have a constitutive document, namely the instrument of incorporation, and it would be governed by a board of directors who were subject to fiduciary duties. Given the above requirements and that offshore privately offered funds were already exempt from profits tax, there would be low incentive for companies to disguise as onshore privately offered OFCs in order to benefit from the current legislative proposal.

20. Members noted that as a measure to prevent abuse, consideration or remuneration received by investment managers for providing investment services to tax-exempt OFCs in the course of a trade or business carried on in Hong Kong would be subject to profits tax. They asked whether such consideration or remuneration would be regarded as capital gain and hence could exempt from profits tax.

21. The Government said that section 26(a) of IRO provided for profits tax exemption of dividends received from corporations which were chargeable to profits tax. Given that a subject OFC (which was a corporation) was chargeable to tax in respect of profits derived from transactions in "non-permissible asset classes", section 26(a) of IRO would apply which might create a loophole by which performance fees and carried interest paid out to investment managers in the form of dividends would be exempt from

tax, when in fact such fees and interest were essentially income or profits (and hence should be chargeable to tax). The proposed measure was intended to plug this possible loophole.

Council question

22. Hon Kenneth LEUNG raised a written question on "Proposed New Open-ended Fund Company Structure" at the Council meeting of 16 April 2014 which sought details of the proposed OFC structure, including comparison with similar regimes of major asset management jurisdictions, investment of OFC assets, and tax regime for OFCs. The question and the Government's written response are hyperlinked in **Appendix II**.

Latest development

23. At the House Committee meeting on 7 July 2017, Members agreed to form a Bills Committee to study the Amendment Bill 2017.

Relevant papers

24. A list of relevant papers is in **Appendix II**.

Council Business Division 1
Legislative Council Secretariat
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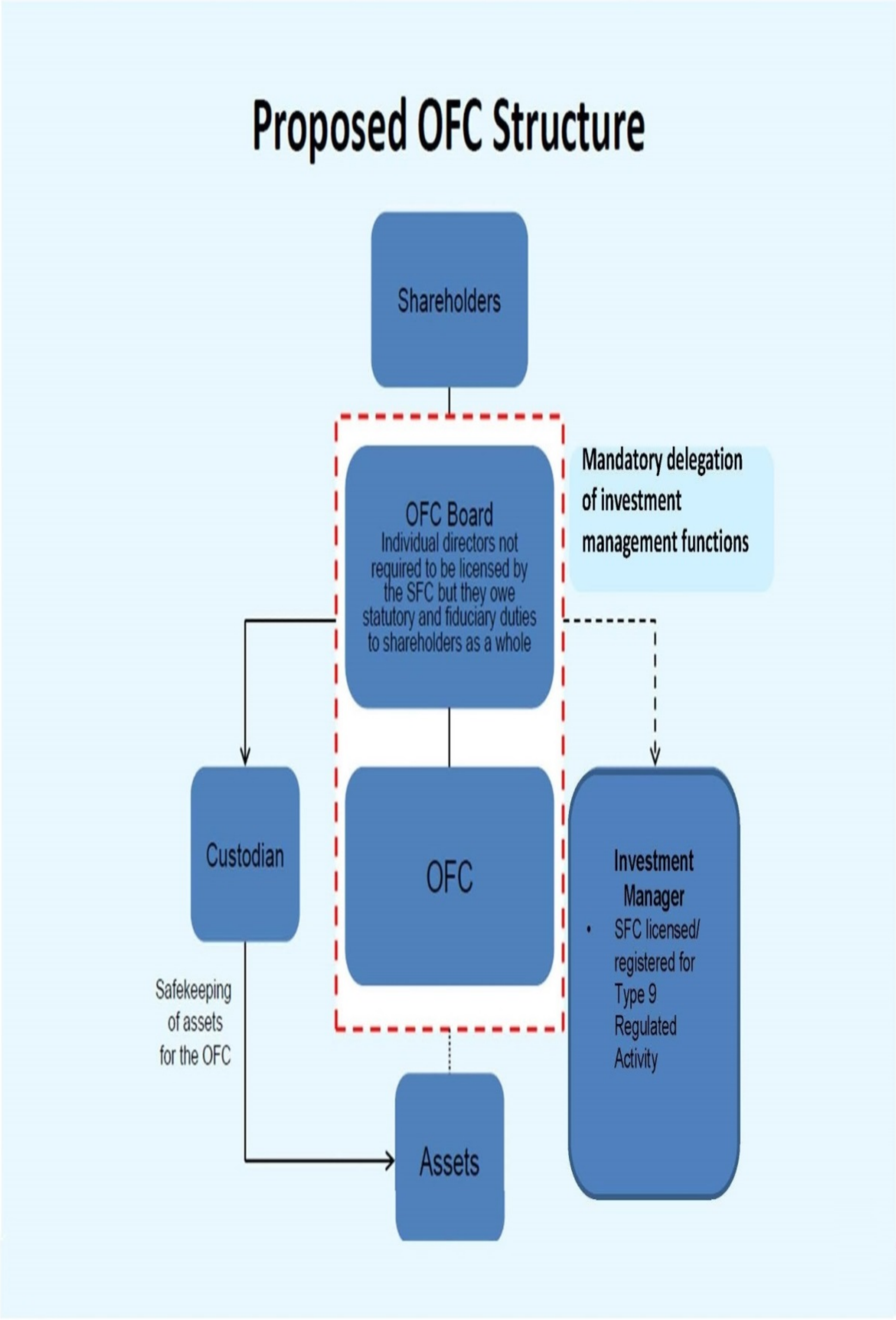
Appendix I



[Source: Slide 8 of the power-point presentation materials provided by the Administration for the meeting of the Bills Committee on the Securities and Futures (Amendment) Bill 2016 on 23 February 2016 (LC Paper No. CB(1)603/15-16(01)).]

Appendix II

List of relevant papers

Date	Event	Paper/Minutes of meeting
18 November 2013	The Financial Services Development Council ("FSDC") released a research paper entitled "Proposals on Legal and Regulatory Framework for Open-ended Investment Companies in Hong Kong"	Press release FSDC's research paper (English version only)
20 March 2014	The Administration launched a public consultation on introducing a new open-ended fund company ("OFC") structure	Press release Consultation paper
7 April 2014	Meeting of the FA Panel	Administration's paper (LC Paper No. CB(1)1180/13-14 (05)) Minutes (paragraphs 40-57) (LC Paper No. CB(1)1996/13-14) Follow-up paper (LC Paper No. CB(1)1316/13-14 (02))
16 April 2014	Hon Kenneth LEUNG raised a written question on the proposed new open-ended fund company structure	Hansard (pages 10095 – 10098)
7 December 2015	FSDC released a paper on the tax issues on OFCs and profits tax exemption for offshore private equity funds	Press release FSDC's paper (English version only)

Date	Event	Paper/Minutes of meeting
15 January 2016	The Administration released the consultation conclusions on OFC structure	Press release Consultation conclusions
2 June 2016	The Legislative Council passed the Securities and Futures (Amendment) Bill 2016	The Bill passed Report of the Bills Committee (LC Paper No. CB(1)896/15-16) Powerpoint presentation materials (LC Paper No. CB(1)603/15-16 (01)) Legislative Council Brief (Ref: SF&C/1/2/22C(2015)) Legal Service Division report (LC Paper No. LS31/15-16)
16 March 2017	Meeting of the FA Panel	Administration's paper (LC Paper No. CB(1)660/16-17 (04)) Background brief (LC Paper No. CB(1)660/16-17 (05)) Minutes (paragraphs 26-42) (LC Paper No. CB(1)1178/16-17)
28 June 2017	The Inland Revenue (Amendment) (No. 4) Bill 2017 was introduced into the Legislative Council	The Bill Legislative Council Brief (File Ref: ASST/3/1/5/1C(2017)Pt.6) Legal Service Division Report (LC Paper No. LS91/16-17)