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20 July 2017

Ms Winnie Lo
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1 Legislative Council Road
Central
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Dear Ms Lo,

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

I refer to your letter of 13 July seeking clarifications in relation to the captioned Bill ("the Amendment Bill"). I am writing to provide further information as requested.

Part I – Legal issues

Clause 1(3) – Commencement (in relation to OTC derivative products)

The Securities and Futures Ordinance ("SFO", Cap. 571) was amended in 2014 to provide for a regulatory framework for the over-the-counter ("OTC") derivatives market in Hong Kong. The regulatory regime is being implemented in stages in tandem with the making of the necessary subsidiary legislation. So far, nine pieces of subsidiary legislation were passed to implement mandatory reporting and clearing obligations under the regime. The next stage will involve the implementation of regulation of intermediaries engaging in OTC derivatives activities, which involve, amongst others, changes to the Securities and Futures (Financial Resources) Rules (Cap. 571N). The Securities and Futures Commission ("SFC") will consult the market before finalising the proposed amendments and expects such to be in place after the OFC regime has come into operation, i.e. after Q2 2018.

Clause 4 – new section 20AH(2)(c)(ii) (in relation to 10 % *de minimis* limit)

As required under the Securities and Futures (Amendment) Ordinance 2016 ("the 2016 Amendment Ordinance") enacted by LegCo in June 2016 to provide for the legal framework for open-ended fund companies ("OFC") as a fund vehicle, an OFC to be set up under the SFO should engage an investment manager licensed by or registered with the SFC to carry out Type 9 (asset management) regulated activity. Consequentially, the investment scope of an OFC should align with such regulated activity. As stated in the Legislative Council Brief on the 2016 Amendment Ordinance (Ref: SF&C/1/2/22C(2015)), the SFC will specify in its future OFC Code the asset classes in which privately offered OFCs may invest (i.e. mainly securities and futures), with a degree of flexibility by allowing a 10% *de minimis* limit for investing in other asset classes. In setting this limit, feedback received during the public consultation on the proposed OFC regime in 2014 has been taken into account. We propose extending the treatment when offering profits tax exemption for privately offered OFCs.

Clause 4 – new sections 20AH(5) to (7) (how to disapply profits tax exemption)

Section 51(6) of the Inland Revenue Ordinance ("IRO", Cap. 112) provides that any person who ceases to carry on any trade, profession or business has to inform the Commissioner of the Inland Revenue ("CIR") in writing within one month of such cessation. If an OFC ceases to carry on a trade, profession or business in Hong Kong, it must notify CIR within one month of such cessation. The OFC will be assessed to tax and recovery procedures will be initiated if it fails to pay the tax assessed.

Clause 4 – new sections 20AH(8) and 20AI(5) (notices to amend Schedule 16A and 16B)

The notices made under the two sections to amend Schedule 16A (classes of assets specified for exemption of profits tax) and Schedule 16B (meaning of non-closely held) are subsidiary legislation subject to negative vetting by the Legislative Council. The two sets of parameters are subject to refinement from time to time in the future in the light of market and other developments.

Clause 4 – new section 20AI(2) (the meaning of "good faith")

The policy intent is that an OFC has to act in good faith in satisfying the ownership requirement under the non-closely held condition. The words "in good faith" are intended to guard against notional but not genuine compliance of the ownership requirement for a non-closely held OFC. Similar wordings (i.e. the Latin equivalent "bona fide") can be found in the IRO, such as the current section 26A(1A)(a)(ii) (relating to profits tax exemption for publicly offered funds) as well as the new section 14G(1) recently added by the Inland Revenue (Amendment) (No. 3) Ordinance 2017 (relating to profits tax concessions to qualifying aircraft lessors and qualifying aircraft leasing managers).

Clause 4 – new section 20AI(4) (appeal mechanism against certain decisions of the CIR)

The proposed new section 20AI(4) provides that the deeming provisions in section 20AI(3) does not apply to an OFC if the CIR is of the opinion that the OFC has failed to take any active steps to meet the ownership requirement set out in section 20AI(2); and the main purpose, or one of the main purposes, of such failure is to avoid, postpone or reduce the company's profits tax liability. The CIR would make enquiries and take into account all the surrounding circumstances before forming an opinion under section 20AI(4) that the OFC has failed to take active steps to meet the ownership requirement for the main purpose, or one of the main purposes, of obtaining a tax benefit. The factors the CIR would consider include –

(a) the actual steps that the OFC has taken or will take for complying with the conditions in the proposed new section 20AI(2);

(b) the reasons for the OFC's failure to take steps to meet the conditions in the proposed new section 20AI(2) and remedial actions the OFC will take to rectify the situation;

(c) the time and resources the OFC has spent or will spend in taking such steps in (a) above;

(d) whether tax liability will be avoided, postponed or reduced as a result of such failure and the quantum of the tax liability involved;

(e) whether there are changes in the financial position of the OFC and/or its associates results arising from such a failure; and

(f) whether such failure is the result of non-commercial arrangements or transactions.

If an assessment is raised on the OFC on the basis of the CIR's decision under the proposed new section 20AI(4), the OFC aggrieved by the assessment may, within one month after the date of the notice of assessment and by notice in writing to the CIR under section 64(1) of the IRO, object to the assessment. It may further appeal against the CIR's determination to the Board of Review within one month after the date of transmission of the determination under section 66(1) of the IRO.

Part II

<u>Clause 4 – new section 20AH(2)(c)(i)</u> (drafting in relation to the 10% *de minimis* limit)

Subject to the 10% *de minimis* limit mentioned above, an OFC should only carry out transactions in assets of a class specified in Schedule 16A, which aligns with Type 9 regulated activity, in order to be qualified for profits tax exemption under the new section 20AH. The new section

20AH(2)(c)(i) aims to set out the limitation on the type of trade, profession or business that a company may carry on, i.e. a trade, profession or business involving transactions in assets of a non-Schedule 16A class. "Non-Schedule 16A class" is a defined term in the new section 20AH to mean a class (of assets) that is not specified in Schedule 16A. The present formulation of the new section 20AH(2)(c)(i) is meant to convey the limitation that is being imposed.

Yours sincerely,

(Renita Au)
for Secretary for Financial Services and the Treasury

c.c. Commissioner of Inland Revenue (Attn: Miss CP Hui)
Law Draftsman (Attn: Ms Francoise Lam and Ms Amy Chan)
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