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THE TAXATION INSTITUTE OF HONG KONG
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The Honorable Kenneth Leung
Chairman of the Bills Committee on
Inland Revenue (Amendment) (No.4) Bill 2017
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road

Dear Honorable Kenneth Leung

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

We refer to the Inland Revenue (Amendment) (No.4) Bill 2017 gazetted on 23 June 2017 which seeks to extend the current profits tax exemption for offshore funds to onshore privately offered open-ended fund companies (OFCs) and would like to state our comments on the Bill as follows.

1. The "non-closely held" (NCH) condition

Under the current draft legislation, one of the conditions that an onshore privately offered OFC must satisfy for enjoying the profits tax exemption is it must be non-closely held. An OFC is non-closely held if it meets the specified criteria in respect of the number of investors and the maximum/minimum participating interest of each investor, etc. and a 24-month grace period is provided in the Bill for a newly set up OFC to meet the NCH condition.

We set out below our views on the NCH condition and consider that the condition should be revisited to address the following issues:

- Since the NCH condition is not present in the existing profits tax exemption regime for offshore or non-resident funds under section 20AC of the Inland Revenue Ordinance (IRO), we would like to seek the HKSAR Government's clarification on why such condition is necessary for onshore privately owned OFCs. This clarification is particularly relevant given that the stated policy objective of the Bill is to extend the current profits tax exemption applicable to offshore funds to onshore OFCs, i.e., a level the playing field between onshore and offshore OFCs. In particular, section 20AC of the IRO, which imposes no NCH requirement, would continue to be applicable to exempting offshore or non-resident OFCs, provided that other exemption conditions are satisfied. As such, imposing the NCH condition on onshore OFCs would not create a level playing field between onshore and offshore OFCs.

- We understand that the HKSAR Government considers that the NCH condition is necessary for preventing a few resident individual or corporate investors who are carrying out

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taxable securities transactions in Hong Kong to repackage their businesses as a tax-exempt OFC. However, this concern would equally apply to the current exemption of offshore funds, i.e. a few resident individual or corporate investors could repackage their otherwise taxable securities transactions in Hong Kong as a tax-exempt offshore fund under section 20AC of the IRO.

- To prevent this possible abuse, the current exemption regime for offshore funds relies not on any NCH conditions but on the deeming provisions contained in section 20AE of the IRO. Under the deeming provisions, a resident investor in a tax-exempt offshore fund would be chargeable to tax in Hong Kong in respect of their beneficial share of the underlying exempted profits of the offshore fund under certain conditions.

- In this regard, we note that the deeming provisions contained in section 20AE of the IRO are essentially reproduced as section 20AK under the Bill to deem a resident investor's beneficial share of the underlying exempted profits of an OFC as profits of the investor chargeable to tax in Hong Kong. As such, we consider that section 20AK would already provide effective safeguards against the possible abuse in the context of the Bill, without the need to rely on the NCH condition.

- In fact, the NCH condition under the Bill could drive many OFCs to be offshore instead of onshore OFCs.

2. The anti-avoidance provision on performance fees/carried interest

The Bill introduces an anti-avoidance provision (i.e. section 20AJ(3)) under which if an OFC is *not exempt from the payment of profits tax*, then despite section 26(a), the consideration or remuneration received by a person in the form of a dividend from the OFC for providing any services in Hong Kong to the OFC will be chargeable to profits tax.

We set out below our comments on this anti-avoidance provision:

- This deeming provision will give rise to double taxation if there is not a corresponding provision allowing the OFC to claim a tax deduction on the amount of dividends distributed to its investment manager in case the same amount is deemed as taxable Hong Kong sourced service fees in the hands of the investment manager under section 20AJ(3). Such double taxation will be contrary to the legislative intent of section 26(a), namely to avoid subject the same profits to taxation again.

- At present, there is not a similar deeming provision in the Inland Revenue Ordinance in respect of distributions made by say, a tax-exempt offshore private equity (PE) fund. Although Departmental Interpretation and Practice Notes No. 51 (DIPN 51) states that distributions / carried interest from a PE fund may be re-characterised / attributed as service fees derived by the fund's investment manager or advisor from management or advisory services rendered in Hong Kong, DIPN 51 stipulates that such re-characterisation / attribution will be made (i) on the basis of applying the general anti-avoidance provisions (i.e. only when the sole or dominant purpose of the arrangement is for obtaining a tax benefit) and (ii) apparently only where the investment manager or advisor is not adequately remunerated for its services or the distributions received by it is not comparable to the return arising on investments made by external investors in the fund. Again, we would like to seek the HKSAR Government's clarification on the justification of the apparently different tax treatments for onshore privately offered OFCs and offshore PE funds.

- In addition, it will be helpful if the HKSAR Government can clarify its views on the following two issues: (i) whether section 26(a) applies to dividends paid out from an OFC that is *chargeable to* but *exempt from the payment* of profits tax (i.e. in the case where the OFC qualifies for the profits tax exemption) and (ii) if the answer to question (i) is yes, based on the current drafting of section 23AJ(3), it seems that the section cannot achieve the legislative intent of the HKSAR Government (i.e. remuneration in the form of dividends received by investment managers for providing any services in the ordinary course of a trade or business carried out in Hong Kong will be chargeable to profits tax), because the section will not apply when an OFC is chargeable to but *exempt* from payment of profits tax.

Should you need our elaboration on any of the points discussed above, please feel free to contact us.

Yours sincerely,

For and on behalf of
The Taxation Institute of Hong Kong

Karmen Yeung
President