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

Purpose

This paper reports on the deliberations of the Bills Committee on Inland Revenue (Amendment) (No. 4) Bill 2017 ("the Bills Committee").

Background

Development of an open-ended fund company structure in Hong Kong

2. At present, 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). There have been calls from the market for a more flexible choice of investment fund vehicle through introducing a new open-ended fund company ("OFC")[1] 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. The introduction of an OFC regime is a key initiative of the Administration to help diversify Hong Kong's fund domiciliation platform and build up its fund manufacturing capabilities.

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[1] An OFC is a collective investment scheme with variable capital set up in the form of a company, but with the flexibility to create and cancel shares for investors' subscription and redemption in the funds. Also, OFCs will not be bound by restrictions on distribution out of capital applicable to conventional companies, and instead may distribute out of capital subject to solvency and disclosure requirements.

3. The enactment of the Securities and Futures (Amendment) Ordinance 2016 ("the Amendment Ordinance 2016") by the Legislative Council ("LegCo") in June 2016 has provided for the legal framework for the OFC structure in Hong Kong. According to the Administration, the Securities and Futures Commission ("SFC"), the principal regulator of OFCs, and relevant government departments are formulating the subsidiary legislation under the Securities and Futures Ordinance (Cap. 571) ("SFO") and code on the operational and procedural details ("OFC Code") with a view to implementing the OFC regime in 2018.[2]

Profits tax treatment

4. Currently, profits tax exemption is given under section 26A(1A) of the Inland Revenue Ordinance (Cap. 112) ("IRO") to publicly offered funds (irrespective of whether their central management and control ("CMC")[3] is located in or outside Hong Kong) authorized by SFC under section 104 of SFO or similar bona fide widely held investment schemes which comply with the requirements of a supervisory authority within an acceptable regulatory regime.[4] The same profits tax exemption will apply to publicly offered OFCs. For privately offered funds, profits tax exemption in respect of profits derived from specified transactions carried out or arranged by specified persons is provided under IRO if they are offshore funds (i.e. with their CMC located outside Hong Kong).[5] As such, profits tax exemption will accordingly apply to offshore privately offered OFCs. Meanwhile, onshore privately offered funds (i.e. with their CMC located in Hong Kong) are still subject to profits tax.

Proposed extension of profits tax exemption to onshore privately offered open-ended fund companies

5. Given the above disparity in tax treatment, most privately offered funds would prefer staying offshore rather than domiciling in Hong Kong using the new OFC regime. In order to remove this disincentive for fund domiciliation

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[2] Source: LegCo Brief on the Inland Revenue (Amendment) (No. 4) Bill 2017 (File Ref: ASST/3/1/5/1C(2017)Pt.6 dated 21 June 2017).

[3] According to the Administration, the CMC test is a well-established common law rule to determine the residence of corporations, partnerships and trust estates.

[4] The tax exemption for publicly offered funds was first introduced in 1983 for unit trusts, 1990 for mutual funds, and 1996 for all types of publicly offered funds.

[5] The tax exemption for offshore funds was implemented in 2006 and was subsequently extended to offshore private equity funds in 2015.

and management in Hong Kong, the Financial Secretary proposed in the 2017-2018 Budget that IRO be amended to extend profits tax exemption to onshore privately offered OFCs (hereinafter referred to as "subject OFCs"). To give effect to the proposal, the Administration has introduced the Inland Revenue (Amendment) (No. 4) Bill 2017 ("the Bill").

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

6. The Bill was gazetted on 23 June 2017, and received its First Reading at the LegCo meeting of 28 June 2017. The Bill seeks to amend IRO to extend profits tax exemption to subject OFCs. Details of the main provisions of the Bill are set out in paragraph 15 of the LegCo Brief on the Bill, and paragraphs 6 to 13 of the Legal Service Division Report on the Bill (LC Paper No. LS91/16-17).

7. The Bill proposes to add a new section 20AH to exempt a subject OFC from paying profits tax on its assessable profits in relation to specified transactions if the specified conditions are met (or regarded under Part 4 of IRO as having been met) at all times during the basic period for a year of assessment. The conditions are, in gist:

(a) Condition 1: the subject OFC must be a resident person;[6]

(b) Condition 2: the subject OFC must be "non-closely held" ("NCH", as defined in the proposed new section 20AI);

(c) Condition 3: the subject OFC must invest in permissible asset classes specified by SFC, but with a degree of flexibility (i.e. 10% *de minimis* limit); and

(d) Condition 4: transactions of the subject OFC must be carried out or arranged by a qualified person.

8. Under the proposed new section 20AH(3), a transaction is eligible for profits tax exemption if it is a transaction in assets of a class specified in the proposed new Schedule 16A, i.e. "permissible asset classes", and the activities that produce assessable profits from the transaction are carried out or arranged in Hong Kong by qualified persons, namely, corporations or authorized

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[6] Under 20AB(2)(b) of IRO, where a person is a corporation that is not a trustee of a trustee estate, the person is to be regarded as a resident person if the CMC of the corporation is exercised in Hong Kong.

financial institutions licensed or registered under SFO to carry on asset management business. A degree of flexibility will be allowed subject to a 10% *de minimis* limit (i.e. a maximum of 10% of the total gross asset value of the fund based on market value) for investing in "non-permissible asset classes".

9. Except for item 8 of the proposed new Schedule 16A in relation to over-the-counter derivative products as defined in Part 1 of Schedule 1 to SFO,[7] the Bill, if passed, will come into operation on the day to be appointed for the commencement of the Amendment Ordinance 2016.

The Bills Committee

10. At the House Committee meeting on 7 July 2017, Members agreed to form a Bills Committee to scrutinize the Bill. Hon Kenneth LEUNG was elected Chairman of the Bills Committee. The membership list of the Bills Committee is in **Appendix I.**

11. The Bills Committee has held two meetings with the Administration. The Bills Committee has invited public views on the Bill, and a total of 11 written submissions have been received. A list of the organizations that have provided written submissions to the Bills Committee is in **Appendix II.** At the request of the Bills Committee, the Administration has provided a consolidated written response to the issues raised in the written submissions.[8]

Deliberations of the Bills Committee

12. Members generally support the Bill and the objectives it seeks to achieve. The major issues and concerns members of the Bills Committee raised during the deliberations of the Bill are summarized in the ensuing paragraphs.

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[7] Item 8 of the proposed new Schedule 16A will 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.

[8] LC Paper No. CB(1)415/17-18(01) issued on 3 January 2018 (https://www.legco.gov.hk/yr16-17/english/bc/bc08/papers/bc08cb1-415-1-e.pdf)

Provision of profits tax exemption to open-ended fund companies

13. The Bills Committee notes that publicly offered funds (irrespective of the locality of their CMC) are regarded to have a lower risk of being used for tax abuse given that they are regulated by SFC and/or the regulator in their home jurisdictions and usually widely held by a large number of investors. In respect of offshore funds (whether publicly or privately offered), the purpose of granting profits tax exemption to such funds is to help attract new offshore funds to invest in Hong Kong and encourage existing ones to continue to invest in Hong Kong. According to the Administration, there were practical difficulties in the past in effectively enforcing the relevant IRO provisions and recovering the tax in respect of cases where the persons carrying out securities transactions are non-residents outside the reach of legal action initiated in Hong Kong, and therefore the Administration's assessment at the time was that the actual cost to revenue of the profits tax exemption to offshore funds should not be significant.

14. Members are aware that over the years, other major fund jurisdictions such as the United Kingdom and Singapore have been increasingly proactive in promoting the development of their onshore fund industry. While noting that there is no onshore privately offered OFC in Hong Kong at present, members agree that it is appropriate to provide tax incentive arrangements for onshore funds so that Hong Kong can remain competitive and be able to meet the development needs of the fund industry. Notwithstanding that, members consider it incumbent upon the Administration to remain mindful of a higher risk of tax abuse for onshore privately offered funds given that residents may be able to convert their taxable profits into non-taxable income more easily via such a fund structure. In this respect, members note that in developing the tax incentive arrangements for the subject OFCs, the Administration has considered the need for anti-avoidance measures and put in place safeguards to prevent abuse.

Conditions for profits tax exemption

Non-closely held condition

15. The Bills Committee notes that the NCH condition aims to ensure that a subject OFC seeking profits tax exemption is not owned by only a few individuals or corporate investors to prevent an individual or a corporate investor who is carrying out securities transactions in Hong Kong and subject to profits tax from abusing the tax exemption by repackaging its business as a subject OFC. For a subject OFC to be regarded as NCH, it has to meet the ownership requirement, the fund document requirement, and the terms and

conditions requirement prescribed under the proposed new section 20AI of the Bill. The proposed new Schedule 16B sets out the criteria for determining whether an OFC is NCH.

16. The Bills Committee notes that the proposed new Schedule 16B sets out the relevant thresholds to be met by a subject OFC that does not have any qualified investor or has one or more qualified investor(s) respectively. These thresholds are in respect of the minimum number of investors, the minimum investment amount, and the percentage caps of the participation interests of various types of investors, originators and their associates[9]. The setting of these thresholds is to ensure that a tax-exempt subject OFC would not be controlled by a small number of investors or by the originator and its associates. The minimum participation interest of different types of investors in terms of investment amount can prevent persons acting in concert by investing only a minimal sum and ensure that a tax-exempt fund has a reasonably large fund size.

17. Regarding the definition of "qualified investor" under the proposed new section 20AI(6), the Chairman has queried if it is too stringent to require an institutional investor to meet all the conditions set out therein, for example those in paragraph (a) of the definition, in order to be regarded as a qualified investor in relation to an OFC. The Administration has advised that in general terms, a "qualified investor" refers to certain specified types of institutional investors, including organizations established for non-profit-making purposes, pension funds, publicly offered funds and governmental entities. The conditions to be met in paragraph (a) of the definition relate to the purposes of the entity, whether it is exempted from income tax in its jurisdiction of residence, and whether it has any shareholders or members who have a proprietary or beneficial interest in its income or assets. Such conditions largely align with those for determining non-profit non-financing entity as adopted by the Organisation for Economic Co-operation and Development ("OECD") and under IRO in the context of automatic exchange of information for tax purposes.

18. Separately, the Bills Committee notes that the Administration has proposed an amendment to the definition of "qualified investor" under the proposed new section 20AI(6) of the Bill to clearly state that sovereign wealth

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[9] Under the proposed new section 20AI(6) of the Bill, "investor", in relation to an OFC, means a person who makes capital commitment to the company, other than the originators or their associates. "Originators", in relation to an OFC, means a person who directly or indirectly (a) originates or sponsors the company; and (b) has the power to make investment decisions on behalf of the company. "Associate" has the meaning given by section 20AC of IRO.

funds ("SWFs"), being a type of institutional investor which commonly has a larger number of underlying investors, shall fall within the definition of "qualified investor". The Bills Committee has no objection to the proposed amendment.

19. The Bills Committee notes that relevant requirements in respect of the fund documents of, and the terms and conditions governing participation in, the subject OFCs are provided under the proposed new section 20AI to ensure that the fund documents reflect that the subject OFC is NCH, and to exclude from tax exemption those OFCs which are available only to specific individuals or corporate investors.

20. The Bills Committee has enquired about the purpose of the requirement under the proposed new section 20AI(2) that the specified conditions should be met "in good faith", as well as the contemplated circumstances under which the specified conditions are otherwise not met "in good faith". The Administration has explained that the term "in good faith" is intended to guard against notional but not genuine compliance of the ownership requirement for an NCH OFC. Similar wordings (i.e. the Latin equivalent "bona fide") can be found in IRO, such as the existing section 26A(1A)(a)(ii) (relating to profits tax exemption for publicly offered funds), etc.

21. Mr CHAN Chun-ying has asked if the Administration has any plan and timetable to review the ownership requirement under the NCH condition in future with a view to attracting funds with a larger number of investors and a reasonably large fund size to domicile in Hong Kong. The Administration has advised that it will review the effectiveness of the proposed profits tax exemption in enhancing Hong Kong's competitiveness as a fund domiciliation location for OFCs at an appropriate juncture in future, and if necessary, may consider adjusting the NCH condition as the market circumstances may warrant. Yet, there is no specific timetable for reviewing the ownership requirement under the NCH condition at this point in time.

22. The Bills Committee notes that in accordance with the proposed new section 20AI(5) of the Bill, the Commissioner of Inland Revenue ("CIR") may by notice published in the Gazette amend the proposed new Schedule 16B regarding the meaning of NCH. Such notice is subject to negative vetting by LegCo.

Tax treatment of investments

23. Regarding the requirement under the proposed new section 20AH(3) that a subject OFC can be eligible for profits tax exemption in respect of

profits derived from transactions in "permissible asset classes" as prescribed in the proposed new Schedule 16A carried out or arranged by a qualified person in Hong Kong, the Chairman has sought clarification on the scope of such "permissible asset classes". He has also enquired about the basis for setting the 10% *de minimis* limit under the proposed new section 20AH(2)(c) for allowing a subject OFC to invest in "non-permissible asset classes", as well as the eligibility of an OFC for profits tax exemption in the event that its investments in "non-permissible asset classes" have exceeded the 10% *de minimis* limit.

24. The Administration has explained that "permissible asset classes" for subject OFCs will largely align with the scope of Type 9 (asset management) regulated activity, which essentially covers securities, futures and over-the-counter derivatives (when the relevant law comes into effect), as well as cash, bank deposits, certificates of deposit, foreign currencies and foreign exchange contracts, as required under section 112Z of the Amendment Ordinance 2016. The investment scope for privately offered OFCs and the 10% *de minimis* rule will be set out in the OFC Code to be issued by SFC. In setting the 10% *de minimis* limit, the Administration has taken into account the feedback received during the public consultation on the proposed OFC regime in 2014. The limit should be met at all times during the basis period for a year of assessment for the exemption of profits tax. In practice, an OFC can rely on the yearly audited financial statements to ascertain whether the 10% *de minimis* limit has been met for a year of assessment. In case an OFC's investments in "non-permissible asset classes", which should be subject to tax, exceed the 10% *de minimis* limit, tax exemption for the OFC will be lost. In other words, all profits of the OFC will be "tainted" and become wholly chargeable to profits tax. On the contrary, if the 10% *de minimis* limit is not exceeded, only profits derived from the transactions in "non-permissible asset classes" will be chargeable to profits tax.

25. The Bills Committee notes that the definition of "securities" in the proposed new Schedule 16A is drawn from SFO and hence includes shares or debentures of overseas private companies but not those of local private companies.[10] As such, under the proposed tax regime, a subject OFC may invest in securities of overseas private companies (i.e. within the permissible asset classes) without a limit, but is subject to a limit of 10% of its gross asset value in respect of its investments in securities of local private companies (i.e. outside the permissible asset classes) under the 10% *de minimis* rule.

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[10] "Securities" is defined under Part 1 of Schedule 1 to SFO. Under this definition, "securities" does not include "shares or debentures of a company that is a private company within the meaning of section 11 of the Companies Ordinance (Cap. 622)".

On this differential tax treatment under the Bill, the Chairman has raised concern about the possibility of the relevant tax feature being considered as ring-fencing and hence a harmful tax practice by the international community under the prevailing international standards, in particular under the Base Erosion and Profit Shifting ("BEPS") package of OECD.[11] He is also worried that there may be a loophole that may give rise to tax leakage since a subject OFC can invest in securities of overseas private companies which can in turn own assets in Hong Kong.

26. To address the above ring-fencing concern and plug the loophole, the Administration has proposed to amend section 20AH of the Bill to remove the 10% *de minimis* rule as well as the tainting provisions. With the proposed amendments, a subject OFC, as long as it has been registered with SFC[12] and meets other requirements in the Bill, would be allowed to enjoy tax exemption on all of its profits, provided that it does not carry on direct trading or a direct business undertaking in Hong Kong involving assets of a non-Schedule 16A class and it does not invest in certain specified types of private companies.

27. The Administration has further elaborated that as an OFC will already be required to comply with the 10% *de minimis* rule as per the OFC Code at the fund regulation level under the supervision of SFC, it is considered not necessary to repeat this rule in the Bill. With the removal of this rule from the Bill, a subject OFC carrying out transactions in the permissible asset classes will continue not to be taxed on its profits arising from such transactions. If it carries out transactions in non-Schedule 16A assets, it will only be assessed to tax under Part 4 (Profits Tax) of IRO in respect of profits arising or derived from direct trading or direct business undertaking in Hong Kong in such assets or utilization of such assets with a view to generating income. The tax exempted profits of the OFC will not be tainted.

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[11] In October 2015, OECD and the Group of Twenty released a package of 15 actions to combat BEPS. Countering harmful tax practices (Action 5) is one of the four minimum standards of the BEPS package. In determining whether a preferential tax regime is potentially harmful, the Forum on Harmful Tax Practice under OECD would take into account a number of factors, one of which is whether the regime is ring-fenced from the domestic economy. "Ring-fencing" occurs when the applicability of a preferential regime is limited to foreign transactions. In such circumstances, the tax base of the jurisdictions from which the geographically mobile activities are attracted will be eroded, whilst the domestic tax base of the jurisdiction providing the regime will not be affected.

[12] A fund has to fulfil the requirements as stipulated under the Amendment Ordinance 2016 as well as the subsidiary legislation and code made/issued by SFC pursuant to the main ordinance to be able to seek for registration as an OFC. SFC would issue a letter of registration to a fund which has successfully been registered as an OFC. There will also be a register of OFCs which can be inspected by the public.

However, if a subject OFC breaches the OFC Rules and/or Code (including the 10% *de minimis* rule) in a way that results in cancellation of registration by SFC, it will simply not be eligible for profits tax exemption.

28. In addition, the Administration has advised that with the proposed amendments to the Bill , a subject OFC can enjoy profits tax exemption on its investment in private companies (whether local or overseas), provided that:

(a) these investee private companies do not hold, directly or indirectly, more than 10% of their assets in immovable property in Hong Kong; and

(b) if a subject OFC has a controlling interest in an investee private company, 50% or more of the private company's assets (that is not immovable property in Hong Kong) should be held for three years or more.

29. The Bills Committee notes that in formulating the above proposed amendments, the Administration has been cognizant of the needs for market development and prevention of tax leakage, while also ensuring that the amendments are in line with the latest international standards under the BEPS package of OECD and the European Union so that the tax incentive would not be labeled as a harmful tax practice. The Administration has consulted the industry on the proposed amendments to the Bill, and the industry generally agrees that the proposed amendments can address the ring-fencing and tax leakage concerns.

30. Expressing support to the proposed amendments, the Chairman has urged the Administration to review if similar ring-fencing feature exists in the current tax regime for offshore privately offered funds and make appropriate legislative amendments as soon as possible.

Transactions be carried out or arranged by a qualified person

31. The Bills Committee notes that in line with the requirement as stipulated under section 112Z of the Amendment Ordinance 2016, it is specified under the proposed new section 20AH(3) of the Bill that the activities that produce the profits from the transactions of the OFC must be carried out or arranged in Hong Kong by corporations or authorized financial institutions licensed or registered under SFO to carry out Type 9 (asset management) regulated activity (i.e. qualified person). The purpose of including this condition is to ensure that a subject OFC enjoying tax

exemption will have substantial activities in Hong Kong and contribute to Hong Kong's economy.

Residence requirement

32. As specified under the proposed new section 20AH(2)(a) of the Bill, a subject OFC eligible for profits tax exemption must be a resident person. Mr CHAN Chun-ying has asked whether IRD will consider issuing certificates of resident status to subject OFCs with a view to facilitating them in seeking tax benefits in other tax jurisdictions which has signed Comprehensive Double Taxation Agreements with Hong Kong.

33. The Administration has advised that a subject OFC will generally be regarded as a tax resident of Hong Kong upon application by the OFC if its CMC is exercised in Hong Kong and its regulated activities are carried out or arranged in Hong Kong by a qualified person. While OECD is formulating its position regarding tax treaty entitlements of investment vehicles relating to the initiative to combat BEPS, the Administration will continue to monitor international developments to ensure that the issue of certificate of residence status to subject OFCs is in accordance with international standards.

Sub-funds of open-ended fund companies

34. The Bills Committee notes that the proposed new section 20AG provides that if the instrument of incorporation of an OFC ("main company") provides for the division of its scheme property into separate parts (each of which is a "sub-fund"), then each sub-fund is to be regarded as an OFC for the purpose of computing the assessable profits of the sub-fund. The Bills Committee has sought clarification about the handling of loss sustained by a sub-fund of an OFC. The Administration has advised that any loss sustained by a sub-fund is not available for setting off against any assessable profits of another sub-fund of the same main company.

Anti-avoidance measures

Duration requirement for meeting the non-closely held condition

35. The Bills Committee notes that pursuant to the proposed new section 20AH(1), a subject OFC is required to satisfy the NCH condition at all times after the date on which an OFC meets the NCH condition, thereby ensuring that a subject OFC is NCH continuously throughout the life of the fund. However, in view that an OFC may take some time to invite subscriptions from investors to meeting the NCH condition, it is provided under the Bill that

a subject OFC can have a maximum 24 months (counting from the date that it accepts its first investor) to meet the NCH condition. In this regard, members have further enquired about the taxability of the profits of an OFC in the event that it has not become NCH within 24 months after the date on which it accepted its first investor, and where an OFC fails to satisfy the NCH condition temporarily (for example, caused by certain investors redeeming their shares and exiting the fund in a short period of time).

36. The Administration has advised that the proposed new sections 20AH(5) to 20AH(7) provide for the disapplication of profits tax exemption to an OFC. Among others, if an OFC has not become NCH within the first 24-month period, the profits tax exemption shall be regarded as never having been granted and the OFC will be chargeable to tax for the whole of the 24-month start-up period. In case of the cessation of a trade, profession or business in Hong Kong, the OFC concerned must notify CIR within one month of such cessation.[13] The OFC concerned will be assessed to tax and recovery procedures will be initiated if it fails to pay the tax assessed. Notwithstanding that, to cater for the actual operation circumstances that an OFC may encounter, safe harbor rules are introduced and set out in the proposed new section 20AJ. Under these rules, an OFC may claim tax exemption even if it fails to meet the NCH condition under certain special circumstances.

37. The Bills Committee notes that under the proposed new section 20AJ, in the event that the NCH condition set out in section 20AH(2)(b) is not met in respect of an OFC, CIR may, on application by the company, nevertheless regard the condition as having been met under certain prescribed circumstances. Pursuant to 20AJ(1)(b), CIR may exercise such discretion if he is satisfied that the failure of the OFC to meet the NCH condition is due to circumstances not reasonably foreseeable by the company and is temporary, and it is fair and reasonable to regard the failure as not having occurred after taking into account all relevant factors. The Bills Committee has asked about how a failure can be regarded as "temporary". The Administration has explained that naturally the term "temporary" shall mean not being "long-term" or "permanent". CIR shall have the discretion to allow flexibility on a case-by-case basis.

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[13] Section 51(6) of IRO provides that any person who ceases to carry on any trade, profession or business has to inform CIR in writing within one month of such cessation.

Tax treatment of carried interest

38. The Bills Committee has sought elaboration on the taxability of carried interest (including the dividends derived from it, and the subsequent income derived from the holding or disposal of such dividends) received by fund executives.

39. The Administration has advised that IRD issued the Departmental Interpretation and Practice Notes ("DIPN") No. 51 on "Profits tax exemption for offshore private equity funds" in May 2016 which provides explanations on, amongst other things, the taxation of investment managers. Such explanations are application to all types of fund structures, including limited partnerships, unit trusts, mutual funds and OFCs, whether onshore or offshore. In gist, carried interest (unless comparable to the return arising on investments made by external investors in a fund) received by investment managers or advisors or fund executives in respect of their professional services provided in Hong Kong, as well as any subsequent income derived from the holding or disposal of such carried interest, will be subject to taxation.

40. The Bills Committee notes that the proposed new section 20AJ(3) includes an express provision to the effect that if an OFC is not exempted from the payment of tax in a year of assessment, the consideration or remuneration that a person received in the form of dividends for providing any services in Hong Kong directly or indirectly to the OFC will be chargeable to tax. As it is stated in DIPN No. 51 that management/performance fees received by investment managers for services rendered in Hong Kong will be assessed (a) on the basis of applying the general anti-avoidance provisions and (b) only where the investment managers or advisors are not adequately remunerated for their services or the distributions received by them are not on an arm's length basis, members have asked about the intent for including the proposed new section 20AJ(3) in the Bill, and whether this provision would go against the above principles set out in DIPN No. 51.

41. The Administration has explained that while a subject OFC will be exempted from the payment of tax in respect of the major part of its profits which is derived from transactions in "permissible asset classes", it is still chargeable to tax in respect of profits derived from certain transactions in "non-permissible asset classes" and investment in certain specified types of private companies. Section 26(a) of IRO provides for profits tax exemption for dividends received from corporations which are chargeable to profits tax. Given that a subject OFC (which is a "corporation") would be chargeable to tax in respect of profits derived from certain transactions/investments, the application of section 26(a) of IRO may create a loophole providing tax

exemption for performance fees and carried interest paid out in the form of dividends to investment managers, when in fact such fees and interest are essentially income or profits derived from management services rendered in Hong Kong (and hence should be chargeable to tax based on the principles set out in DIPN No. 51). To plug this loophole, the abovementioned express provision in section 20AJ(3) has been included in the Bill with a view to ensuring that consideration or remuneration received by a person for providing investment services, directly or indirectly, for the OFC in the course of a trade or business carried in Hong Kong will be chargeable to profits tax.

42. Meanwhile, the Administration has confirmed that the proposed new section 20AJ(3) does not affect the general tax principles that are currently applicable in determining whether carried interest or performance fees are taxable. It also does not affect the current treatment of expense deduction, i.e. the consideration or remuneration (e.g. management/performance fees) paid to investment managers and charged in the accounts of an OFC as an expense would be allowed for tax deduction for the OFC to the extent that it has been incurred for producing chargeable profits.

Deeming provisions for resident provisions

43. The Bills Committee notes that to prevent possible abuse or round-tripping by a resident person disguising as a subject OFC to take advantage of the proposed tax exemption, the Bill contains deeming provisions as set out in the proposed new section 20AK under which a resident person who, alone or jointly with his associates, holds direct and/or indirect beneficial interest of 30% or more in a tax-exempt OFC or sub-fund, will be deemed to have derived assessable profits in respect of the trading profits earned by the OFC. The same arrangement is already in place for the offshore fund tax exemption under IRO.

44. Members share the view expressed by an organization in its written submission on the Bill that as the deeming provisions are only applicable to residents, the proposed regime may be considered to be ring-fenced from the domestic market and thus a harmful tax practice by OECD. Members consider it incumbent upon the Administration to ensure that the proposed tax regime will not be in violation of the latest international standards.

45. The Administration has stressed that the proposed tax regime for the subject OFCs is in keeping with the principles under the BEPS package of OECD. Under the proposed tax regime, tax exemption is provided to the subject OFCs at the fund level and not at the investor level. In other words, non-resident investors will continue to be subject to taxation in their

jurisdictions of residence whereas resident investors will be subject to profits tax in Hong Kong if their interests in the OFC equal or exceed 30%. In essence, the deeming provisions should be aimed at residents, in view that non-residents generally may not be subject to Hong Kong tax under a double tax agreement in the absence of a permanent establishment. The Administration is of the view that the proposed tax regime is for activities within a defined scope with real economic substance in Hong Kong and necessary safeguards, and hence should not be regarded as a harmful tax practice by OECD. That said, the Administration will continue to monitor the latest developments in the international community.

46. The Chairman has further enquired about the implementation of this deeming provision, such as whether the resident person concerned is required to proactively make declaration on the deemed assessable profits. The Chairman has also sought clarifications of the handling of tax assessment under the proposed new section 20AK(7) where a resident person is liable to tax in respect of the profits of an OFC by having an indirect beneficial interest in the company through one or more interposed person(s) and one or more of these interposed person(s) is a non-resident person.

47. The Administration has explained that in the tax return form, there is an item which requires declaration of deemed assessable profits derived from OFCs (now applicable to offshore funds). The proposed new section 20AK(7) aims to avoid double taxation such that the resident person who is liable to tax in respect of the profits of an OFC under subsection (a) can be discharged from the person's liability to tax in respect of the profits in case any of the interposed person is already a resident and is already also liable to tax in respect of the profits of the OFC.

Appeal mechanism against certain decisions of the Commissioner of Inland Revenue

48. The Bills Committee notes that the proposed new section 20AI(4) of the Bill provides for the power of CIR not to regard an OFC as NCH under certain circumstances. In this regard, the Bills Committee has asked about the factors which CIR will take into account in exercising such power, and whether any person aggrieved by CIR's decision under the proposed new section 20AI(4) may appeal to the Board of Review referred to in section 65 of IRO.

49. The Administration has explained that the proposed new section 20AI(4) provides that the deeming provision in section 20AI(3) does not apply to an OFC if 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. 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 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 meeting the conditions therein and remedial actions it 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 arising from such a failure; and (f) whether such failure is the result of non-commercial arrangements or transactions.

50. As regards the appeal mechanism, the Administration has explained that if an assessment is raised on an OFC on the basis of 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 CIR under section 64(1) of IRO, object to the assessment. It may further appeal against CIR's determination to the Board of Review within one month after the date of transmission of the determination under section 66(1) of IRO.

Financial and economic implications of the extension of profits tax exemption to onshore privately offered OFCs

51. Members have requested the Administration to provide a projection of the financial and economic implications of the extension of profits tax exemption to the subject OFCs, such as the number of privately offered OFCs expected to be established in Hong Kong, and the number of jobs expected to be created in the financial services industry.

52. The Administration has advised that the proposal to grant profits tax exemption to the subject OFCs would be conducive to enhancing Hong Kong's competitiveness in respect of the domiciliation of privately offered OFCs, and thereby generating demand for local asset management, investment and advisory services, as well as other relevant professional services. This will help strengthen Hong Kong's position as an international asset management centre and foster the further development of Hong Kong's

financial services industry as a whole. However, as the decision with respect to fund domiciliation is essentially a commercial decision which depends on a number of factors, the Government cannot project the number of subject OFCs that will be established in Hong Kong or the number of jobs created by them. Meanwhile, the proposal should essentially not give rise to tax revenue loss given that the subject OFC is non-existent in Hong Kong currently.

Proposed amendments to the Bill

53. Having regard to the Bills Committee's view about possible concerns of the international community over ring-fencing on certain tax features and the tax treatment of investments by the subject OFC in private companies, the Administration has proposed amendments to the Bill, as explained in detail in paragraphs 25 to 29 above. It has also proposed an amendment to include SWFs under the definition of "qualified investor" (paragraph 18 above refers). The Bills Committee supports in principle the amendments proposed by the Administration, and will not propose amendments to the Bill.

Resumption of the Second Reading debate

54. The Bills Committee does not object to the resumption of the Second Reading debate on the Bill at the Council meeting of 21 March 2018.

Consultation with the House Committee

55. The Bills Committee reported its deliberations to the House Committee on 23 February 2018.

Council Business Division 1
Legislative Council Secretariat
15 March 2018

Appendix I

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

Membership List

Chairman	Hon Kenneth LEUNG
Members	Hon James TO Kun-sun Hon WONG Ting-kwong, GBS, JP Hon Charles Peter MOK, JP Dr Hon KWOK Ka-ki Hon IP Kin-yuen Dr Hon Junius HO Kwan-yiu, JP Hon CHAN Chun-ying (Total: 8 members)
Clerk	Ms Doris LO
Legal Adviser	Miss Rachel DAI

Appendix II

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

Organizations which have provided written submissions to the Bills Committee

1. Hong Kong Bar Association
2. The Hong Kong Society of Financial Analysts
3. PricewaterhouseCoopers Limited
4. The Hong Kong Association of Banks
5. The Hong Kong Institute of Chartered Secretaries
6. Joint Liaison Committee on Taxation
7. Democratic Alliance for the Betterment and Progress of Hong Kong
8. Deloitte Advisory (Hong Kong) Limited
9. Hong Kong Investment Funds Association
10. Hong Kong Institute of Certified Public Accountants
11. The Taxation Institute of Hong Kong