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22 June 2017

Clerk to Panel on Financial Affairs
Legislative Council Complex
1 Legislative Council Road
Central
Hong Kong
(Attn: Mr Hugo Chiu)

Dear Mr Chiu,

**Panel on Financial Affairs
Follow-up to meeting on 5 June 2017**

I refer to your letter of 6 June requesting the Government to provide information in respect of **“Agenda Item V – Subsidiary legislation and code relating to the open-ended fund company regime”** as a follow-up action arising from the meeting of the Legislative Council (“LegCo”) Panel on Financial Affairs on 5 June 2017. I am writing to provide further information as requested.

(a) Measures to avoid abuse of stamp duty and profits tax exemption granted to OFCs

Under the Securities and Futures (Amendment) Ordinance 2016 (“the 2016 Amendment Ordinance”) enacted by LegCo in June 2016, an open-ended fund company (“OFC”) must engage an investment manager licensed by or registered with the Securities and Futures Commission (“SFC”) to carry out Type 9 (asset management) regulated activity. Consequentially, the investment scope of an OFC as allowed by the SFC would align with such regulated activity (i.e. mainly securities and futures). Meanwhile, in view of the asset classes in which privately offered funds would commonly invest, privately offered OFCs will further be allowed to

invest in foreign exchange contracts, bank deposits, foreign currencies, certificates of deposit and cash.

The existing profits tax regime applicable to funds will be applicable to OFCs. Specifically, under the current Inland Revenue Ordinance (Cap. 112) (“IRO”), publicly offered funds (whether onshore or offshore) and offshore funds (whether publicly offered or privately offered) are exempt from profits tax. Publicly offered OFCs and offshore OFCs would therefore be tax-exempt. For these funds, anti-abuse measures already in place include sections 20AE and 20AF of the IRO which prevent a resident person from round-tripping. Also, should there be suspicion of any abuse to avoid the liability of tax, the Inland Revenue Department can rely on the general anti-avoidance provisions under sections 61 and 61A of the IRO to take appropriate follow-up actions. These include arrangements to counteract the tax benefit which would otherwise be obtained.

Meanwhile, we will be introducing the Inland Revenue (Amendment) (No. 4) Bill 2017 (“the Bill”) into LegCo to extend profits tax exemption to onshore privately offered OFCs (“subject OFCs”). A copy of the LegCo Brief, enclosing with it the Bill, is attached.

To prevent abuse of the exemption, we have included in the Bill certain conditions and anti-abuse safeguards. The conditions are to ensure that a tax-exempt subject OFC is non-closely held and of a reasonable fund size, and that the transactions must be carried out through or arranged by a qualified person in Hong Kong in the permissible asset classes. Details can be found in paragraphs 6 to 12 of the LegCo Brief. The subject OFCs enjoying the tax benefits would be subject to the same anti-round tripping provisions applicable to resident persons and the general anti-tax avoidance provisions as mentioned above.

As for stamp duty, the 2016 Amendment Ordinance has extended the same arrangements and anti-abuse measures currently applicable to unit trust schemes under the Stamp Duty Ordinance (Cap. 117) to OFCs¹.

¹ Stamp duty exemption is given to (a) transfers of units/shares under listed unit trust schemes/OFCs (which are exchange-traded funds); and (b) transfers of units/shares under unlisted unit trust schemes/OFCs by way of allotment and redemption. Stamp duty is payable on the sale and purchase of units/shares under unlisted unit trust schemes/OFCs.


(b) Measures to prevent a company from abusing the tax exemption for OFCs by packaging its business (like real estate) in the form of an OFC

Real estate is not within the permissible asset classes for OFCs and profits derived from transactions in it will not be tax-exempt. There should thus not be any concern over investors disguising as OFCs to invest in real estate and avoid tax.

(c) Whether there will be any loophole for tax avoidance if the proposed amendment bill is not enacted by LegCo

The Bill proposing to extend profits tax exemption to the subject OFCs comprises measures to prevent tax avoidance. It will be tabled before LegCo on 28 June 2017.

Yours sincerely,



(Renita Au)

for Secretary for Financial Services and the Treasury

Encl.

c.c. Commissioner of Inland Revenue (Attn: Miss CP Hui)

LEGISLATIVE COUNCIL BRIEF

Inland Revenue Ordinance
(Chapter 112)

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

INTRODUCTION

A At the meeting of the Executive Council on 20 June 2017, the Council **ADVISED** and the acting Chief Executive **ORDERED** that the Inland Revenue (Amendment) (No. 4) Bill 2017 (“the Bill”), at **Annex A**, should be introduced into the Legislative Council (“LegCo”) to implement the 2017-18 Budget initiative of extending profits tax exemption to privately offered open-ended fund companies (“OFCs”) with their central management and control (“CMC”) exercised in Hong Kong.

JUSTIFICATIONS

Benefits to the financial services industry

2. Asset management is a fast-growing sector within the financial services industry.¹ While Hong Kong has established itself as a premier international asset management centre, our asset management industry is mostly related to fund distribution and marketing activities. To keep our competitive edge and enable the industry to continue to develop and grow, we need to strengthen Hong Kong’s role in the manufacturing and management of funds. More importantly, we need to encourage the domiciliation of funds in Hong Kong. This is because fund creation activities will drive demand for professional services such as fund management and investment advice, as well as legal, accounting,

¹ At the end of 2015 (year with latest available figures), the combined fund management business in Hong Kong amounted to \$17,393 billion.

administration and other ancillary services, in addition to sales and marketing.

3. In June 2016, LegCo enacted the Securities and Futures (Amendment) Ordinance 2016 (“2016 Amendment Ordinance”) to provide a legal framework for the OFC² structure in Hong Kong. This is a key initiative to help diversify Hong Kong’s fund domiciliation platform and build up our fund manufacturing capabilities. With the introduction of the new form of investment fund vehicle, we hope that more funds, both publicly and privately offered ones, would choose to domicile in Hong Kong, thereby promoting fund origination and diversifying the development of our asset management industry. The Securities and Futures Commission (“SFC”), the principal regulator of OFCs as provided under the 2016 Amendment Ordinance, and relevant departments are formulating the subsidiary legislation and code on the operational and procedural details with a view to implementing the OFC regime in Q2 2018.

Levelling the playing field

4. Having just the legal regime for a new fund vehicle is not sufficient. Parity of tax treatment is another consideration influencing the choice of jurisdiction for fund domiciliation and management. As an on-going effort to promote fund creation and management in Hong Kong, publicly offered funds (whether their CMC is exercised in or outside Hong Kong) authorised by the SFC and offshore funds (whether publicly or privately offered) are already exempted from profits tax under our current taxation regime. Yet, onshore privately offered funds are still subject to profits tax. In other words, when the OFC regime comes into operation, publicly offered OFCs (whether their CMC is exercised in or outside Hong Kong) and offshore OFCs (whether publicly or privately offered) will be exempted from profits tax, while onshore privately offered OFCs cannot enjoy the same exemption. Given such disparity in tax treatment, most privately offered funds would prefer staying offshore rather than domiciling in Hong Kong using the new OFC regime. Therefore, we need to remove this disincentive for fund domiciliation and management in Hong Kong by amending the Inland Revenue Ordinance

² 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, which is currently not enjoyed by conventional companies. 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.

(Cap. 112) (“the Ordinance”) to extend profits tax exemption to **onshore privately offered OFCs (hereinafter referred to as “subject OFCs”)**.

5. Given the lack of presence of the subject OFCs in Hong Kong so far, our current proposal to bring their profits tax treatment on par with that of other OFCs should not result in any loss in tax revenue. While the proposal would mean that the subject OFCs’ profits derived from transactions in “permissible asset classes” (see paragraphs 9 and 10 below) in Hong Kong will not be subject to tax at the fund level, the consideration or remuneration received by investment managers for providing investment services to tax-exempt OFCs in Hong Kong will still be chargeable to profits tax. We have made this clear in our legislative proposal (see paragraph 12(d) below).

Our Proposal

6. We propose that a privately offered OFC should satisfy the four conditions as set out in paragraphs 7 to 11 below in order to be able to enjoy profits tax exemption. The conditions seek to provide safeguards to prevent abuse.

Condition 1: The OFC must be a Hong Kong resident person

7. A subject OFC eligible for profits tax exemption must be a resident person with its CMC³ exercised in Hong Kong. In other words, it must be an onshore fund.

Condition 2: The OFC must be “non-closely held”

8. A subject OFC eligible for profits tax exemption cannot be closely held. This aims to ensure that such an OFC is not owned by only a few individuals or corporate investors. Otherwise, an individual or a corporate investor who is carrying out securities transactions in Hong Kong and subject to profits tax may abuse the tax exemption by repackaging its business as a subject OFC. It is also our policy intent to grant tax exemption to certain wholesale funds. While wholesale funds normally have only one institutional investor⁴ and a few other investors,

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

⁴ Examples of institutional investors include funds established for non-profit-making purposes, pension funds, funds invested in by a publicly offered fund (i.e. fund of funds) and funds with a governmental entity as the major institutional investor.

it is not uncommon for such funds to have a larger number of underlying investors. The details of the proposed “**non-closely held**” condition (hereinafter referred to as “**NCH condition**”) are set out at **Annex B**.

Condition 3: The OFC must invest in permissible asset classes specified by the SFC

9. The SFC will specify in its OFC Code the asset classes that privately offered OFCs may invest in. Such investment scope should largely align with the SFC’s Type 9 (asset management) regulated activity, i.e. mainly securities and futures (“permissible asset classes”), with a degree of flexibility by allowing 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”.

10. We propose that a subject OFC be eligible for profits tax exemption in respect of profits derived from transactions in permissible asset classes as specified in the OFC Code carried out through or arranged by a qualified person in Hong Kong (see Condition 4 below).

Condition 4: Transactions of the OFC must be carried out through or arranged by a qualified person

11. We propose that the activities that produce the profits from the transactions must be carried out through or arranged in Hong Kong by corporations or authorised financial institutions licensed or registered under the Securities and Futures Ordinance (Cap. 571) (“SFO”) (“qualified persons”) to carry out Type 9 regulated activity. This is to ensure that a subject OFC enjoying tax exemption would have substantial activity in Hong Kong and contribute to Hong Kong’s economy by hiring local investment managers. The requirement for an OFC to have an investment manager licensed or registered for Type 9 regulated activity has already been stipulated in the 2016 Amendment Ordinance. With this requirement, the investment scope of the OFC should also align with such regulated activity (i.e. Condition 3 above).

Measures to prevent abuse

12. To prevent possible abuse of the proposed tax exemption, we suggest including in the Bill the following measures –

- (a) a subject OFC can have 24 months to meet the NCH condition counting from the acceptance of its first investor.

It can enjoy tax exemption during this 24-month start-up period irrespective of whether the NCH condition can be met. Yet, to prevent individuals or entities from taking advantage of the tax exemption in the first 24-month period (e.g. by repeatedly opening and closing a subject OFC every 24 months), a subject OFC will be required to continue to meet the NCH condition for a further period of 24 months after the 24-month start-up period (section A of **Annex B**). Otherwise, we will “dis-apply” the tax exemption and the OFC will then be chargeable to tax for the 24-month start-up period;

- (b) profits of a subject OFC derived from transactions of the “non-permissible asset classes” (if any) (paragraphs 9 and 10 above) will be subject to tax. This is to prevent a fund from converting taxable income (e.g. gains from sales of Hong Kong immovable properties) to non-taxable income via an OFC structure. 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. If the 10% *de minimis* limit is exceeded, the tax exemption of the subject OFC will be lost (i.e. all profits will be wholly chargeable to profits tax);
- (c) 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-fund⁵, will be deemed to have derived assessable profits in respect of the trading profits earned by the OFC. This aims to prevent abuse or round-tripping by a resident person disguising as a subject OFC to take advantage of the exemption. The same arrangement is already in place for the offshore fund tax exemption under the Ordinance and is not new; and
- (d) 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 should be chargeable to profits tax. Currently, section 26(a) of the Ordinance provides for profits tax exemption of dividends received from corporations which are chargeable to profits tax. As a subject OFC (which is

⁵ Sub-funds are described in more details in paragraph 15(a)(i) below.

a “corporation”) is chargeable to tax in respect of profits derived from transactions in “non-permissible asset classes”, section 26(a) of the Ordinance will apply. As a result, performance fees and carried interest paid out in the form of dividends to investment managers will be exempt from tax, when in fact such fees and interest are essentially income or profits (and hence should be chargeable to tax). We therefore propose to include an express provision to address the situation arising from the existing provisions.

13. We are mindful of the need for tax incentive schemes to meet the latest international standards under the Base Erosion and Profit Shifting (“BEPS”) package, so as to avoid double non-taxation or the shifting of profits to low-tax regimes. We are satisfied that the proposed tax regime for the subject OFCs, being an onshore scheme for activities within a defined scope with real economic substance in Hong Kong and necessary safeguards, should **not** be regarded as a harmful tax practice by the Organisation for Economic Co-operation and Development.⁶

OTHER OPTIONS

14. We must amend the Ordinance to give effect to the proposed extension of profits tax exemption to the subject OFCs. There are no other options.

THE BILL

15. The main provisions of the Bill are as follows –

- (a) clause 4 of the Bill adds new sections 20AG to 20AL to the Ordinance –
 - (i) the new section 20AG provides that if the instrument of incorporation of an OFC 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

⁶ Countering harmful tax practice (Action 5) is one of the minimum standards under the BEPS package of the Organisation for Economic Co-operation and Development. This BEPS Action seeks to revamp the work on harmful tax practices with priority on improving transparency and on requiring substantial activity for any preferential tax regime.

regarded as an OFC for the purpose of computing the assessable profits of the sub-fund⁷;

- (ii) the new section 20AH exempts an OFC from paying profits tax on its assessable profits in relation to certain transactions if certain conditions are met⁸;
- (iii) the new sections 20AI and 20AJ set out the interpretation provisions and supplementary provisions for the new section 20AH. The new section 20AJ(3) includes an express provision to the effect that if an OFC is not exempt from the payment of tax, the consideration or remuneration that a person received, in the form of a dividend from the company, for providing any services, directly or indirectly, to the company is chargeable to tax;
- (iv) the new section 20AK provides that the assessable profits of an OFC are to be regarded as the assessable profits of a resident person if the resident person has, during any period of time, a beneficial interest, whether direct or indirect or both, in an OFC to the extent that the person, either alone or jointly with any

⁷ An OFC may be created as an umbrella fund or the “main company”, meaning that the OFC can consist of a number of separately pooled sub-funds and each sub-fund would have a pool of assets that is managed in accordance with the investment objectives and policies for that particular sub-fund. Operationally, each sub-fund would be distinct with, for example, separate accounts, valuations and share prices. We propose to also grant tax exemption to a sub-fund which can meet the four conditions set out in paragraphs 7 to 11 above. Also, in keeping with section 112S of the 2016 Amendment Ordinance which provides for the segregated liability of sub-funds, the assets of a sub-fund of a main company must not be used to discharge the tax liabilities of any other sub-fund of the same main company, and that any liability incurred on behalf of a sub-fund may only be discharged out of its assets.

⁸ The new section 20AH(4) provides that an OFC is not exempt from payment of tax for a year of assessment in respect of its assessable profits for the year of assessment from incidental transactions (i.e. transactions incidental to the carrying out of the transactions in permissible asset classes as specified in the new Schedule 16A) if the trading receipts of the OFC from incidental transactions in the year of assessment exceeds 5% of the total of the trading receipts of the company and its incidental transactions in that year of assessment. If the 5% threshold is exceeded, the whole trading receipts from the incidental transactions will be chargeable to profits tax. This is in line with the current offshore fund taxation regime.

of the person's associates, holds not less than 30% of the issued share capital of the OFC⁹; and

- (v) the new section 20AL sets out the circumstances under which the losses sustained by an OFC from certain transactions are available, or not available, for set-off against the assessable profits of the OFC. By virtue of section 20AG, this section also applies to a sub-fund;
- (b) clause 5 adds a new Schedule 15B to the Ordinance to deal with ascertaining the amount of assessable profits of a resident person under section 20AK. This new schedule follows the existing schedules governing the calculation of such assessable profits¹⁰; and
- (c) clause 6 adds new Schedules 16A and 16B to the Ordinance. Schedule 16A sets out the classes of assets specified for the purposes of section 20AH. Schedule 16B sets out the criteria for determining whether an OFC is non-closely held. Both Schedules may be amended by the Commissioner of Inland Revenue by notice published in the Gazette (new section 20AH(8) and new section 20AI(5)).

LEGISLATIVE TIMETABLE

16. The legislative timetable will be –

Publication in the Gazette	23 June 2017
First Reading and commencement of Second Reading debate	28 June 2017
Resumption of Second Reading debate, committee stage and Third Reading	To be notified

⁹ The purpose of this new section is to prevent abuse or round-tripping by a resident person disguising as an eligible onshore OFC to take advantage of the exemption.

¹⁰ The existing schedules in the Ordinance are for the purpose of calculating the assessable profits of a resident person with direct and/or indirect beneficial interest of 30% or more in an offshore fund. Similarly, we need a new schedule to provide for the calculation of the assessable profits of similar resident persons in a subject OFC.

COMMENCEMENT

17. Save for item 8 of Schedule 16A regarding over-the-counter (“OTC”) derivative products, the Bill will come into operation on the day appointed for the commencement of the 2016 Amendment Ordinance such that the profits tax exemption can be implemented in tandem with the commencement of the OFC regime, currently planned for Q2 2018. Item 8 of Schedule 16A will come into operation on the day appointed for the commencement of section 53(8) of the Securities and Futures (Amendment) Ordinance 2014 (“2014 Amendment Ordinance”), which provides for an expanded definition of Type 9 (asset management) regulated activity to include the management of OTC derivative products.¹¹

IMPLICATIONS OF THE PROPOSAL

18. The Bill is in conformity with the Basic Law, including the provisions concerning human rights. It will not affect the current binding effect of the existing provisions of the Ordinance. There are no productivity, environmental, family or gender implications, and no sustainability implications other than the economic implications set out in paragraph 20 below. There are also no civil service implications to the Government as the Inland Revenue Department will absorb the additional workload using its existing resources.

19. On financial implications, the proposal to grant tax exemption to the subject OFCs would mean that OFCs’ profits arising in or derived from Hong Kong would not be subject to tax at the fund level. It should, however, be noted that the proposal should essentially not give rise to tax revenue loss given the lack of presence of the subject OFCs in Hong Kong so far. Also, the OFCs would likely choose to stay offshore to be able to enjoy profits tax exemption if there is no similar tax exemption treatment for the subject OFCs. On the other hand, the remuneration received by investment managers for providing investment services and by other professionals for providing auxiliary services to tax-exempt OFCs in the course of a trade or business carried on in Hong Kong will

¹¹ This means that, when section 53(8) of the 2014 Amendment Ordinance commences, OTC derivative products will become a permissible asset class for the subject OFCs.

By way of background, the 2014 Amendment Ordinance provides for a regulatory framework for the OTC derivatives market in Hong Kong. The regulatory regime is being implemented in stages after the making of the necessary subsidiary legislation.

still be chargeable to profits tax.

20. On economic implications, the proposal would be conducive to enhancing Hong Kong's competitiveness in respect of the domiciliation of privately offered OFCs, thereby generating demand for local asset management, investment and advisory services, as well as other relevant professional services. This would help strengthen Hong Kong's position as an international asset management centre and foster the further development of our financial services industry as a whole.

PUBLIC CONSULTATION

21. From January to April 2016, we consulted the industry on the concept to extend profits tax exemption to the subject OFCs. We consulted the industry again in March 2017 on our proposal. The industry generally welcomes the proposal as it would bring more business opportunities to the local fund industry, and most comments were on the technical parameters. We have considered the views received in formulating the legislative proposal.

22. We briefed the LegCo Panel on Financial Affairs on the proposal on 16 March 2017. Members generally supported the proposal.

PUBLICITY

23. We will issue a press release and arrange the gazettal of the Bill. We will also arrange a spokesperson to answer media enquiries.

BACKGROUND

24. The Financial Secretary announced in the 2016-17 Budget that the Government would provide a legal framework for introducing an OFC structure to further diversify the fund domiciliation platform in Hong Kong. The 2016 Amendment Ordinance was passed by LegCo in June 2016. The Financial Secretary further announced in the 2017-18 Budget that the Government would extend the profits tax exemption to the subject OFCs.

ENQUIRIES

25. Enquiries relating to this brief can be directed to Miss Carrie Chang, Principal Assistant Secretary for Financial Services and the Treasury (Financial Services), at 2810 2054.

Financial Services Branch
Financial Services and the Treasury Bureau
21 June 2017

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

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A BILL

To

Amend the Inland Revenue Ordinance to extend profits tax exemption to certain open-ended fund companies the central management and control of which is exercised in Hong Kong; and to provide for related matters.

Enacted by the Legislative Council.

1. Short title and commencement

- (1) This Ordinance may be cited as the Inland Revenue (Amendment) (No. 4) Ordinance 2017.
- (2) Subject to subsection (3), this Ordinance comes into operation on the day appointed for the commencement of the Securities and Futures (Amendment) Ordinance 2016 (16 of 2016).
- (3) Section 6 (in so far as it relates to item 8 of the new Schedule 16A) comes into operation on the day appointed for the commencement of section 53(8) of the Securities and Futures (Amendment) Ordinance 2014 (6 of 2014).

2. Inland Revenue Ordinance amended

The Inland Revenue Ordinance (Cap. 112) is amended as set out in sections 3 to 6.

3. Section 20AB amended (interpretation of sections 20AC, 20ACA, 20AD, 20AE and 20AF and Schedules 15 and 15A)

- (1) Section 20AB, heading—

Repeal

everything after “**20AE**”

Substitute

“, **20AF, 20AG, 20AH, 20AI, 20AJ, 20AK and 20AL and Schedules 15, 15A, 15B, 16A and 16B**”.

- (2) Section 20AB(1)—

Repeal

everything after “**20AE**”

Substitute

“, **20AF, 20AG, 20AH, 20AI, 20AJ, 20AK and 20AL and Schedules 15, 15A, 15B, 16A and 16B**”.

4. Sections 20AG to 20AL added

After section 20AF—

Add

“20AG. Sub-funds of open-ended fund companies

- (1) If the instrument of incorporation of an open-ended fund company (*main company*) provides for the division of its scheme property into separate parts (each of which is a *sub-fund*), then, when applying section 14 to the main company—
- (a) a reference to assessable profits in that section is a reference to the total of the assessable profits of all of its sub-funds; and
 - (b) for computing the assessable profits of the sub-funds—
 - (i) each sub-fund is to be regarded as an open-ended fund company;
 - (ii) the main company is to be regarded as not being an open-ended fund company; and

- (iii) the provisions of this Part apply to a sub-fund as if it were an open-ended fund company.
- (2) The part of the profits tax chargeable on a main company that is attributable to the assessable profits of one of its sub-funds may only be paid out of the assets of the sub-fund.
- (3) If the conditions for exemption from payment of tax under section 20AH are met (or regarded under this Part as having been met) in respect of a sub-fund, the sub-fund is exempt under that section even if the conditions are not met (or not regarded under this Part as having been met) in respect of another sub-fund of the same main company.
- (4) Any loss sustained by a sub-fund from a transaction referred to in section 20AH(1)(a) or (b) is not available for set off against any assessable profits of another sub-fund of the same main company.
- (5) In this section—
- scheme property* (計劃財產) has the meaning given by section 112A of the Securities and Futures Ordinance (Cap. 571).

20AH. Certain profits of certain open-ended fund companies exempt from payment of tax

- (1) If, in respect of an open-ended fund company, all the conditions set out in subsection (2) are met, or regarded under this Part as having been met, at all times during the basis period for a year of assessment, the company is exempt from the payment of tax otherwise chargeable under this Part in respect of its assessable profits for the period from—

- (a) qualifying transactions within the meaning of subsection (3); and
- (b) subject to subsection (4), transactions incidental to the carrying out of qualifying transactions (*incidental transactions*).
- (2) The conditions are—
- (a) that the company is a resident person;
- (b) that the company is non-closely held; and
- (c) either—
- (i) the trade, profession or business carried on by the company in Hong Kong does not involve transactions in assets of a non-Schedule 16A class; or
- (ii) the trade, profession or business carried on by the company in Hong Kong involves transactions in assets of a non-Schedule 16A class but the percentage calculated according to the following formula does not exceed 10%—
- $$A/B \times 100\%$$
- where—
- A = value of all the company's assets of a non-Schedule 16A class;
- B = value of all the company's assets.
- (3) For the purposes of this section, a transaction is a qualifying transaction if—
- (a) it is a transaction in assets of a class specified in Schedule 16A; and
- (b) the activities that produce assessable profits from the transaction—

- (i) are carried out in Hong Kong by or through a qualified person; or
 - (ii) are arranged in Hong Kong by a qualified person.
- (4) The company is not exempt under subsection (1) from the payment of tax in respect of its assessable profits for the basis period from incidental transactions if the percentage calculated according to the following formula exceeds 5%—

$$A/B \times 100\%$$

where—

A = the company's trading receipts from incidental transactions in the period;

B = the total of the company's trading receipts from qualifying transactions and incidental transactions in the period.

- (5) Despite subsection (1), if the company is exempt under that subsection because the company is regarded as non-closely held, and the company has not become non-closely held within 24 months after the day on which it accepts its first investor, the exemption is to be regarded as never having been granted.
- (6) Despite subsection (1), if the company is exempt under that subsection because the company is regarded as non-closely held, and—
- (a) within 24 months after the first day on which the company is regarded as non-closely held, the company becomes non-closely held (*qualifying event*); and
 - (b) within 24 months after the day of the qualifying event—

- (i) the company ceases to carry on a trade, profession or business in Hong Kong; or
 - (ii) the company ceases to be non-closely held, the exemption is to be regarded as never having been granted.
- (7) Despite subsection (1), if the company is exempt under that subsection because the company has become non-closely held (*material event*), and within 24 months after the day of the material event—
- (a) the company ceases to carry on a trade, profession or business in Hong Kong; or
 - (b) the company ceases to be non-closely held, the exemption is to be regarded as never having been granted.
- (8) The Commissioner may by notice published in the Gazette amend Schedule 16A.
- (9) In this section—
- non-Schedule 16A class*** (非附表 16A 類別) means a class that is not specified in Schedule 16A;
- qualified person*** (合資格人士) means a corporation licensed under Part V of the Securities and Futures Ordinance (Cap. 571) to carry on, or an authorized financial institution registered under that Part for carrying on, a business in Type 9 regulated activity as referred to in Part 1 of Schedule 5 to that Ordinance.
- (10) For the purposes of subsections (5), (6) and (7)—
- (a) ***non-closely held*** (非集中擁有)—see section 20AI(2); and
 - (b) ***regarded as non-closely held*** (視為非集中擁有)—see section 20AI(3).

20AI. Interpretation of section 20AH: meaning of non-closely held

- (1) This section applies to the interpretation of section 20AH.
- (2) An open-ended fund company is non-closely held if all the following conditions are met in good faith by the company—
 - (a) for a company that does not have any qualified investor—
 - (i) the company has at least the number of investors specified in Schedule 16B;
 - (ii) for at least 10 investors of the company, the participation interest of each of them exceeds the amount specified in Schedule 16B;
 - (iii) the participation interest of each investor does not exceed the percentage of the company's issued share capital specified in Schedule 16B; and
 - (iv) the participation interest of the originators and their associates does not exceed the percentage of the company's issued share capital specified in Schedule 16B;
 - (b) for a company that has one or more qualified investors—
 - (i) the company has at least the number of investors specified in Schedule 16B;
 - (ii) the participation interest of each qualified investor exceeds the amount specified in Schedule 16B;

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- (iii) for at least 4 investors (not being qualified investors) of the company, the participation interest of each of them exceeds the amount specified in Schedule 16B;
 - (iv) the participation interest of each investor (not being a qualified investor) does not exceed the percentage of the company's issued share capital specified in Schedule 16B; and
 - (v) the participation interest of the originators and their associates does not exceed the percentage of the company's issued share capital specified in Schedule 16B;
- (c) the company's instrument of incorporation and its prospectus contain—
- (i) a statement that the company is non-closely held; and
 - (ii) a specification of the intended categories of investors of the company (*specification*);
- (d) the specification, or other terms and conditions (whether or not contained in the instrument or prospectus referred to in paragraph (c)) governing participation in the company, do not have the effect of—
- (i) limiting the investors of the company to a specific group of associates; or
 - (ii) deterring a reasonable investor belonging to an intended category of investors of the company from investing in the company.
- (3) Further, the company is regarded as non-closely held during the period beginning on the day the company

accepts its first investor and ending on whichever is the earlier of the following dates—

- (a) the date on which the company becomes non-closely held under subsection (2);
 - (b) the expiry date of the period of 24 months after the day on which the company accepts its first investor.
- (4) Subsection (3) does not apply to an open-ended fund company if—
- (a) the Commissioner is of the opinion that—
 - (i) the company has failed to take any active steps to meet the conditions set out in subsection (2); and
 - (ii) the main purpose, or one of the main purposes, of such failure is to avoid, postpone or reduce the company's liability to tax under this Part; or
 - (b) the company has indicated to the Commissioner that it intends subsection (3) not to apply to it.
- (5) The Commissioner may by notice published in the Gazette amend Schedule 16B.
- (6) In this section and Schedule 16B—

associate (相聯者) has the meaning given by section 20AC;

central bank (中央銀行) has the meaning given by section 50A;

entity (實體) has the meaning given by section 50A;

governmental entity (政府實體) has the meaning given by section 50A but does not include a governmental entity that exercises commercial functions;

international organization (國際組織) has the meaning given by section 50A;

investor (投資者), in relation to an open-ended fund company, means a person who makes capital commitment to the company, other than the originators or their associates;

jurisdiction of residence (居留司法管轄區) has the meaning given by section 50A;

originator (發起人), in relation to an open-ended fund company, 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;

participation interest (參與權益), in relation to an open-ended fund company, means the issued share capital of the company held by the company's investors, originators or originators' associates;

qualified investor (合資格投資者), in relation to an open-ended fund company, means any of the following—

- (a) an institutional investor that meets all of the following conditions—
 - (i) it is established and operated in its jurisdiction of residence exclusively for religious, charitable, scientific, artistic, cultural, athletic or educational purposes;
 - (ii) it is exempt from income tax in its jurisdiction of residence;
 - (iii) it has no shareholders or members who have a proprietary or beneficial interest in its income or assets;

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- (iv) its formation documents or the applicable laws of its jurisdiction of residence do not permit its income or assets to be distributed to, or applied for the benefit of, a private person or non-charitable entity—
 - (A) other than pursuant to the conduct of the institutional investor's charitable activities;
 - (B) other than as payment of reasonable compensation for services rendered; or
 - (C) other than as payment representing the fair market value of a property which the institutional investor has purchased;
 - (v) its formation documents or the applicable laws of its jurisdiction of residence require all of its assets to be distributed to a governmental entity or other non-profit organization, or to be escheated to the government of the jurisdiction or a political subdivision of the government, on the institutional investor's liquidation or dissolution;
- (b) a scheme—
- (i) that is a collective investment scheme authorized under section 104 of the Securities and Futures Ordinance (Cap. 571); or
 - (ii) that is similarly constituted under the law of a place outside Hong Kong and, if it is regulated under the law of the place, is permitted to be operated under the law of the place;

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- (c) a registered scheme, or its constituent fund, as defined by section 2(1) of the Mandatory Provident Fund Schemes Ordinance (Cap. 485), or—
 - (i) a person who, in relation to a registered scheme, is an approved trustee or service provider, as defined by section 2(1) of that Ordinance; or
 - (ii) a person who is an investment manager of a registered scheme or constituent fund;
 - (d) an entity established to provide retirement, disability or death benefits (or a combination of any of them) to beneficiaries who are current or former employees (or persons designated by such employees) of one or more employers in consideration for services rendered, and—
 - (i) the entity does not have a single beneficiary with a right to more than 5% of the entity's assets;
 - (ii) the entity is subject to government regulation and provides information reporting to the tax authorities; and
 - (iii) the entity meets any of the following conditions—
 - (A) the entity is generally exempt from tax on investment income, or taxation of such income is deferred or taxed at a reduced rate, owing to the entity's status as a retirement or pension plan;
 - (B) the entity receives at least 50% of its total contributions (other than transfers of assets from other entities described in

- this paragraph) from the sponsoring employers;
- (C) distributions or withdrawals from the entity are allowed only on the occurrence of specified events related to retirement, disability or death (except rollover distributions to other entities described in this paragraph or to funds described in paragraph (f)), or penalties apply to distributions or withdrawals made before such specified events;
 - (D) contributions (other than certain permitted make-up contributions) by an employee to the entity are limited by reference to the earned income of the employee;
- (e) a governmental entity;
 - (f) a fund established by a governmental entity, international organization, central bank or the Hong Kong Monetary Authority to provide retirement, disability or death benefits to beneficiaries or participants who—
 - (i) are current or former employees (or persons designated by such employees); or
 - (ii) are not current or former employees, if the benefits provided to such beneficiaries or participants are in consideration for personal services rendered for the governmental entity, international organization, central bank or the Hong Kong Monetary Authority.

20AJ. Supplementary provisions for section 20AH

- (1) If the condition set out in section 20AH(2)(b) is not met in respect of an open-ended fund company (*failure*), the Commissioner may, on application by the company, nevertheless regard the condition as having been met in respect of the company if—
 - (a) the Commissioner is satisfied that—
 - (i) the failure is due to the winding down of the company's activities and investments; and
 - (ii) the company has notified its investors that its activities and investments are being wound down; or
 - (b) the Commissioner is satisfied that—
 - (i) the failure is due to circumstances not reasonably foreseeable by the company;
 - (ii) the failure is temporary; and
 - (iii) it is fair and reasonable to regard the failure as not having occurred after taking into account all relevant factors, including—
 - (A) the cause, nature, extent and duration of the failure; and
 - (B) the remedial actions taken by the company to address the failure, and the speed of taking such actions.
- (2) If an open-ended fund company carries on a trade, profession or business in Hong Kong involving transactions in assets of a non-Schedule 16A class and the condition set out in section 20AH(2)(c)(ii) is not met (*failure*), the Commissioner may, on application by the company, nevertheless regard the condition as having

been met in respect of the company if the Commissioner is satisfied that the failure is temporary and due to circumstances not reasonably foreseeable by the company, including—

- (a) fluctuations in the value of the company's assets; and
 - (b) redemptions by investors beyond the company's control.
- (3) If an open-ended fund company is not exempt from the payment of tax chargeable under this Part in a year of assessment, then despite section 26(a), the consideration or remuneration that a person received, in the form of a dividend from the company, for providing any services in Hong Kong, directly or indirectly, to the company is chargeable to tax under this Part.
- (4) In this section—

non-Schedule 16A class (非附表 16A 類別) means a class that is not specified in Schedule 16A;

services (服務), in relation to an open-ended fund company, includes—

- (a) seeking funds for the company from participants or potential participants;
- (b) researching potential investments to be made for the company;
- (c) acquiring, holding, managing or disposing of property for the company; and
- (d) acting for the company with a view to assisting an entity in which the company has made an investment to raise funds.

20AK. Assessable profits of open-ended fund companies regarded as assessable profits of resident person

- (1) If—
 - (a) a resident person has, during any period of time, a beneficial interest, whether direct or indirect or both, in an open-ended fund company to the extent set out in subsection (2); and
 - (b) the company is exempt from the payment of tax under section 20AH,

the assessable profits of the company for the period of time that would have been chargeable to tax under this Part but for that section are to be regarded as the assessable profits arising in or derived from Hong Kong of the resident person for the year of assessment from a trade, profession or business carried on by the resident person in Hong Kong.
- (2) The extent is that the resident person, either alone or jointly with any of the resident person's associates (whether a resident person or not), holds or is interested in not less than 30% of the issued share capital of the company.
- (3) If—
 - (a) a resident person has, during any period of time, a beneficial interest, whether direct or indirect or both, in an open-ended fund company that is exempt from the payment of tax under section 20AH; and
 - (b) the company is an associate of the resident person,

the assessable profits of the company for the period of time that would have been chargeable to tax under this Part but for that section are to be regarded as the

assessable profits arising in or derived from Hong Kong of the resident person for the year of assessment from a trade, profession or business carried on by the resident person in Hong Kong.

- (4) Subsections (1) and (3) apply in relation to a resident person irrespective of whether the person has received, or will receive, directly or indirectly, from the open-ended fund company concerned any money or other property representing the profits of the company for the relevant year of assessment.
- (5) The extent of a resident person's beneficial interest in an open-ended fund company is to be determined in accordance with Part 2 of Schedule 15B.
- (6) The amount regarded as the assessable profits of a resident person for a year of assessment under subsection (1) or (3) is to be ascertained in accordance with Schedule 15B.
- (7) If—
 - (a) a resident person is liable to tax in respect of the profits of an open-ended fund company by the operation of subsection (1) or (3) by reason of the person's having an indirect beneficial interest in the company through an interposed person or through a series of 2 or more interposed persons; and
 - (b) the interposed person or any of the interposed persons is a resident person who is also liable to tax in respect of the profits by the operation of subsection (1) or (3),

the resident person mentioned in paragraph (a) is discharged from the person's liability to tax in respect of the profits.

(8) In this section—

associate (相聯者) has the meaning given by section 20AC.

20AL. Losses from section 20AH(1) transactions and non-Schedule 16A transactions

(1) If an open-ended fund company is exempt from the payment of tax under section 20AH in respect of its assessable profits in a year of assessment, any loss sustained by the company from a transaction referred to in section 20AH(1)(a) or (b) in the year of assessment is not available for set off against any assessable profits of the company in the year of assessment or any subsequent year of assessment.

(2) If an open-ended fund company is not exempt from the payment of tax under section 20AH in respect of its assessable profits in a year of assessment, any loss sustained by the company from a transaction referred to in section 20AH(1)(a) or (b) in the year of assessment is only available for set off against any assessable profits of the company from transactions referred to in section 20AH(1)(a) or (b) in the year of assessment or any subsequent year of assessment.

(3) Any loss sustained by an open-ended fund company from a non-Schedule 16A transaction in a year of assessment is only available for set off against any assessable profits of the company from non-Schedule 16A transactions in the year of assessment or any subsequent year of assessment.

(4) In this section—

non-Schedule 16A class (非附表 16A 類別) means a class that is not specified in Schedule 16A;

non-Schedule 16A transaction (非附表 16A 交易) means a transaction in assets of a non-Schedule 16A class.”.

5. Schedule 15B added

After Schedule 15A—

Add

“Schedule 15B

[ss. 20AB & 20AK]

Provisions for Ascertaining Amount of Assessable Profits of Resident Person under Section 20AK

Part 1

1. The amount regarded as the assessable profits of a resident person for a year of assessment is the total sum arrived at by adding up the assessable profits of the open-ended fund company that would have been chargeable to tax under Part 4 but for section 20AH (*exempt profits*) for each day in the period in the year of assessment during which the resident person has a direct or indirect beneficial interest in the company.
2. For the purposes of section 1 of this Part, the exempt profits of an open-ended fund company for a particular day in a year of assessment are to be ascertained in accordance with the following formula—

$$A = \frac{B \times C}{D}$$

where—

- A = the exempt profits of the company for a particular day in a year of assessment;
- B = the extent of the resident person's beneficial interest in the company on the particular day, expressed as a percentage determined in accordance with Part 2 of this Schedule;
- C = the exempt profits of the company for the accounting period of the company in which the particular day falls;
- D = the total number of days in the accounting period of the company in which the particular day falls.

Part 2

1. Where a resident person has a direct beneficial interest in an open-ended fund company, the extent of the beneficial interest of the resident person in the company is the percentage of the issued share capital of the company held by the resident person.
2. Where a resident person has an indirect beneficial interest in an open-ended fund company, the extent of the beneficial interest of the resident person in the company is—
 - (a) if there is only one interposed person, the percentage arrived at by multiplying the percentage representing the extent of the beneficial interest of the resident person in the interposed person by the percentage representing the extent of the beneficial interest of the interposed person in the company; or
 - (b) if there is a series of 2 or more interposed persons, the percentage arrived at by multiplying the percentage representing the extent of the beneficial

interest of the resident person in the first interposed person in the series by—

- (i) the percentage representing the extent of the beneficial interest of each interposed person (other than the last interposed person) in the series in the next interposed person in the series; and
- (ii) the percentage representing the extent of the beneficial interest of the last interposed person in the series in the company.

3. For the purposes of section 2 of this Part—

- (a) section 1 of this Part applies in determining the extent of the beneficial interest of a resident person in an interposed person as if references to an open-ended fund company in that section were references to an interposed person;
- (b) section 1 of this Part applies in determining the extent of the beneficial interest of an interposed person in an open-ended fund company as if references to a resident person in that section were references to an interposed person; and
- (c) section 1 of this Part applies in determining the extent of the beneficial interest of an interposed person (*Interposed Person A*) in another interposed person (*Interposed Person B*) as if—
 - (i) references to a resident person in that section were references to Interposed Person A; and
 - (ii) references to an open-ended fund company in that section were references to Interposed Person B.”.

6. Schedules 16A and 16B added

After Schedule 16—

Add

“Schedule 16A

[ss. 20AB, 20AH, 20AJ
& 20AL]

**Classes of Assets Specified for Purposes of Section
20AH**

1. Securities as defined in Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571).
2. Futures contracts as defined in Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571).
3. Foreign exchange contract under which the parties to the contract agree to exchange different currencies on a particular date.
4. Deposits (as defined in section 2(1) of the Banking Ordinance (Cap. 155)) made with a bank (as defined in Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571)).
5. Foreign currencies.
6. Certificates of deposit as defined in Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571).

7. Cash.
8. OTC derivative products as defined in Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571).

Schedule 16B

[ss. 20AB & 20AI]

Meaning of Non-closely Held

1. For an open-ended fund company that does not have any qualified investor—
 - (a) the company has at least 10 investors;
 - (b) for at least 10 investors of the company, the participation interest of each of them exceeds \$20,000,000;
 - (c) the participation interest of each investor does not exceed 50% of the company's issued share capital; and
 - (d) the participation interest of the originators and their associates does not exceed 30% of the company's issued share capital.
2. For an open-ended fund company that has one or more qualified investors—
 - (a) the company has at least 5 investors;

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- (b) the participation interest of each qualified investor exceeds \$200,000,000;
 - (c) for at least 4 investors (not being qualified investors) of the company, the participation interest of each of them exceeds \$20,000,000;
 - (d) the participation interest of each investor (not being a qualified investor) does not exceed 50% of the company's issued share capital; and
 - (e) the participation interest of the originators and their associates does not exceed 30% of the company's issued share capital.”.
- _____

Explanatory Memorandum

The object of this Bill is to amend the Inland Revenue Ordinance (Cap. 112) (*principal Ordinance*) to extend profits tax exemption to certain open-ended fund companies the central management and control of which is exercised in Hong Kong.

2. Clause 4 adds new sections 20AG to 20AL to the principal Ordinance.
3. The new section 20AG provides that if the instrument of incorporation of an open-ended fund 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 open-ended fund company for computing the assessable profits of the sub-fund.
4. The new section 20AH exempts an open-ended fund company from paying profits tax on its assessable profits in relation to certain transactions if certain conditions are met.
5. The new sections 20AI and 20AJ respectively set out the interpretation provisions and supplementary provisions for the new section 20AH.
6. The new section 20AK provides that the assessable profits of an open-ended fund company are to be regarded as the assessable profits of a resident person (within the meaning of section 20AB(2) of the principal Ordinance) under certain circumstances.
7. The new section 20AL sets out the circumstances under which the losses sustained by an open-ended fund company from certain transactions are available, or not available, for set off against the assessable profits of the company. By virtue of the new section 20AG, the new section 20AL also applies to a sub-fund.

8. Clause 5 adds a new Schedule 15B to the principal Ordinance to deal with ascertaining the amount of assessable profits of a resident person under the new section 20AK.
9. Clause 6 adds new Schedules 16A and 16B to the principal Ordinance. The new Schedule 16A sets out the classes of assets specified for the purposes of the new section 20AH. The new Schedule 16B sets out the criteria for determining whether an open-ended fund company is non-closely held. Both Schedules may be amended by the Commissioner of Inland Revenue by notice published in the Gazette (new section 20AH(8) and new section 20AI(5)).

Requirements for the “non-closely held” condition

An onshore privately offered open-ended fund company (hereinafter referred to as “subject OFC”) will be regarded as “non-closely held” subject to fulfilling the following requirements (hereinafter referred to as “NCH condition”) –

A. Ownership requirement

- (a) at all times after the date on which an OFC meets the NCH condition or on expiry of the first 24 months after a subject OFC accepts its first investor, **where the OFC has one or more than one qualified investor** –
 - (i) the number of investors¹ in the OFC who are not the originator and the originator’s associates is at least five;
 - (ii) the participation interest of a qualified investor in the OFC exceeds \$200 million;
 - (iii) for at least four investors (not being qualified investors) in the OFC, the participation interest of each of them exceeds \$20 million;
 - (iv) the participation interest of each investor (not being a qualified investor) does not exceed 50%; and
 - (v) the participation interest of the originator and the originator’s associates in the OFC does not exceed

¹ An investor in a subject OFC can be a natural person or a person as defined in section 2 of the Inland Revenue Ordinance (Cap.112) (which includes “a corporation, partnership, trustee, whether incorporated or unincorporated, or body of persons”). Should there be suspicion of any abuse of the NCH condition to avoid the liability of tax, the Inland Revenue Department will rely on the existing anti-avoidance provisions under sections 61 and 61A of the Ordinance to take appropriate follow-up action. These include arrangements to counteract the tax benefit which would otherwise be obtained. The new section 20AK will also prevent abuse or round-tripping by resident persons (please see paragraph 12(c) of the main paper).

30%;

- (b) at all times after the date on which an OFC meets the NCH condition or on expiry of the first 24 months after a subject OFC accepts its first investor, **where the OFC has no qualified investor** –
 - (i) the number of investors in the OFC who are not the originator and the originator’s associates is at least ten;
 - (ii) for at least ten investors in the OFC, the participation interest of each of them exceeds \$20 million;
 - (iii) the participation interest of each investor does not exceed 50%; and
 - (iv) the participation interest of the originator and the originator’s associates in the OFC does not exceed 30%.

A “qualified investor” means certain specified types of institutional investors, including organisations established for non-profit-making purposes, pension funds, publicly offered funds and governmental entities.

As it takes time for a fund to establish a track record and attract investors, we propose to allow a maximum of 24 months for a subject OFC to meet the NCH condition, i.e. such OFC can enjoy profits tax exemption in its 24-month start-up period after it accepts its first investor even if it cannot yet meet the NCH condition.

B. Fund document requirement

- (c) at all times the fund documents –
 - (i) contain a statement that shares in the subject OFC will not be closely held; and
 - (ii) specify the intended categories of investors;

C. Terms and conditions requirement

- (d) at all times neither –
 - (i) the specification of the intended categories of investors; nor
 - (ii) any other terms or conditions governing participation in the fund, whether or not specified in the fund documents;

have a limiting or deterring effect .

2. In coming up with the criteria for the ownership requirement under section A above, we have taken into account –

- (a) empirical data provided by the industry on fund size vis-à-vis number of investors. Generally speaking, the number of investors would go up as assets under management (“AUM”) in a fund increase. It is quite common for funds with AUM below \$390 million (or US\$50 million) to have about five investors and for those with AUM between \$390 million and \$780 million (or between US\$50 million and \$100 million) to have around ten investors. We have therefore adopted “five” and “ten”, depending on whether there is any “qualified investor”, as the minimum number of investors that a subject OFC, which should not be held (and hence controlled) by a small number of investors, should have in order for it to be eligible for the profits tax exemption;
- (b) industry feedback suggests that institutional investors prefer to hold a substantial stake in a fund so that it would not be easily affected by the mobility of small investors. Thus, when there is a qualified investor in a subject OFC, we reckon that it would prefer holding at least 50% participation interest. According to industry data, a qualified investor should hence be required to invest at least \$200 million (roughly equals to \$390 million (fund size mentioned in (a) above) × 50%). This should also help ensure that a subject OFC is of a reasonably large fund size; and

- (c) to ensure that a subject OFC is not held (and hence controlled) by a small number of investors, we will not allow any non-qualified investor to hold a particularly large stake of the OFC. Hence, the participation rate of any non-qualified investor should not exceed 50% and that of the originator and its associates should not exceed 30%. Meanwhile, the participation interest of a non-qualified investor should exceed \$20 million (roughly equals \$780 million (fund size mentioned in (a) above) \times 20% \div 9 investors).

3. The purposes of the three requirements under sections A to C above are as follows –

- (a) **A subject OFC is required to satisfy the NCH condition at all times after the date on which an OFC meets the NCH condition or on expiry of the first 24 months after the OFC accepts its first investor** (section A above). This is to ensure that a subject OFC is non-closely held continuously throughout the life of the fund. In view that an OFC may take some time to invite subscriptions from investors to meet the NCH condition, a subject OFC can have a maximum of 24 months (counting from the date that it accepts its first investor) to meet the NCH condition.
- (b) **It must have a minimum number of investors** (section A above) so that a tax-exempt subject OFC would not be held (and hence controlled) by a small number of investors.
- (c) **The participation interests of various types of investors must meet relevant percentage caps and levels** (section A above). The purpose of the percentage cap of different types of investors is to ensure that a tax-exempt subject OFC is not controlled by a small number of investors or by the originator and the originators' associates. Meanwhile, the minimum participation interest of different types of investors in terms of amount is to prevent persons acting in concert by investing only a minimal sum and to ensure that a tax-exempt fund has a reasonably large fund size.
- (d) A subject OFC complying with the NCH condition should also meet the **fund document requirement** (section B) and **terms and conditions requirement** (section C). Privately

offered funds normally target specific categories of investors. These requirements aim to ensure that the fund documents reflect that the subject OFC is non-closely held, and to exclude from tax exemption OFCs which are available only to specific individuals or corporate investors, whether such limitation is achieved by a specific rule set out in the fund documents or by the imposition of terms and conditions that would have the effect of deterring investors from investing in the fund.

Safe harbour rules

4. To cater for the actual operation circumstances that an OFC may encounter, we have introduced safe harbour rules under which a subject OFC may claim, by application to the Commissioner of Inland Revenue (“CIR”), tax exemption even if it fails to meet any of the three requirements under the NCH condition under at least one of the following two special circumstances –

- (a) the subject OFC’s activities and investments are being wound down and it has sent notices to its members notifying them of the decision to wind down its activities and investments; or
- (b) the subject OFC can continue to be treated as being “non-closely held” having regard to temporary and out-of-control circumstances (e.g. a significant number of investors redeeming their shares and exiting the fund in a short period of time owing to market fluctuations).

5. In addition, considering that compliance with the 10% *de minimis* limit may depend on fluctuations in market value or other circumstances that are out of the OFC’s control, there is another safe harbour rule under which a subject OFC may claim tax exemption by application to the CIR, provided that it can satisfy the CIR that the 10% threshold is exceeded due to temporary failure and circumstances not reasonably foreseeable by the company, including (a) fluctuations in the value of the assets of the company; and (b) redemptions by investors beyond the company’s control.