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Bills Committee on Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018

Background brief

Purpose

This paper provides background information on the Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018 ("the Bill") and summarizes the major views expressed by members when the Panel on Financial Affairs ("FA Panel") was consulted on the legislative proposal.

Background

2. Currently, profits tax exemption is given under the Inland Revenue Ordinance (Cap. 112) ("IRO") to publicly offered funds, both onshore and offshore (i.e. irrespective of whether their central management and control ("CMC")¹ is located in or outside Hong Kong). For privately offered funds, there is different treatment for onshore and offshore funds. At present, offshore privately offered and offshore privately equity funds (collectively known as "offshore funds" hereafter) (i.e. with their CMC exercised outside Hong Kong) enjoy profits tax exemption. Onshore privately offered funds, with the exception of privately offered open-ended fund companies ("OFCs"),² cannot enjoy profits tax exemption.

¹ Funds with their central management and control ("CMC") exercised in Hong Kong are regarded as "onshore funds". Those with their CMC exercised outside Hong Kong are regarded as "offshore funds". The CMC test is well established in common law for determining the residence of corporations, partnerships and trusts.

² To diversify the fund management platform, the Administration has put in place a legal framework for a new fund structure in the form of open-ended fund companies ("OFCs") in Hong Kong. The OFC regime allows funds to be 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. The OFC regime commenced operation on 30 July 2018, with the passage of the Inland Revenue (Amendment) (No.2) Ordinance 2018.

3. According to the Administration, the Council of the European Union ("EU") has identified Hong Kong's tax regimes for offshore funds to be problematic on account of their ring-fencing features, i.e. preferential tax treatment is partially or fully isolated from the domestic economy.³ Hong Kong's tax regimes are considered harmful by EU as IRO currently only provides profits tax exemption to offshore, but not onshore funds and only allows offshore funds to have profits tax exemption with investment in private companies incorporated overseas but not locally.

4. To further consolidate Hong Kong's competitive edge in the manufacturing and management of funds and in order not to be put on the EU's list of non-cooperative jurisdictions for tax purposes, the Administration announced in the 2018-2019 Budget that a review would be conducted on the existing tax concession arrangements applicable to the fund industry with regard to the international requirements on tax co-operation in order to address EU's concerns. Specifically, Hong Kong has committed to look into how to modify the tax regimes for offshore funds to address EU's concerns about ring-fencing, and introduce the corresponding legislative amendments into the Legislative Council ("LegCo") by end-2018.

The Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018

5. The Bill was gazetted on 7 December 2018, and received its First Reading at the LegCo meeting of 12 December 2018. The Bill seeks to amend IRO to provide profits tax exemption to eligible funds operating in Hong Kong, regardless of the structure under which they are established or their CMC location. The key aspects of the proposal are summarized in paragraphs 6 to 12 below.

Eligibility for profits tax exemption for funds

6. The Bill seeks to add a new section 20AM to IRO to define the term "fund", similar to the definition of "collective investment scheme" in Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571). It is proposed that an entity that meets the definition of "fund" and fulfills the specified

³ Ring-fencing may take different forms, e.g. excluding resident taxpayers from taking advantage of the preferential tax treatment; and prohibiting qualifying resident taxpayers from operating in the domestic market. Qualifying resident taxpayers can be implicitly excluded from operating in the domestic market if the applicability of the preferential tax treatment is limited to transactions carried out with foreign parties.

person⁴ or qualifying fund⁵ requirements will be able to enjoy profits tax exemption on its profits generated from the following transactions regardless of its CMC location or its structure –

- (a) transactions in assets of a class specified in the proposed Schedule 16C of the Bill ("qualifying transactions");
- (b) transactions incidental to the carrying out of qualifying transactions ("incidental transactions"), subject to a 5% limit; and
- (c) if the fund is an OFC, transactions in non-qualifying assets⁶ ("non-qualifying transactions").

7. For a fund setting up special purpose entities ("SPEs") for the sole purpose of holding and administering investment in private investee companies, it is proposed that tax exemption will be provided at both the fund level, and if there is SPE, the SPE level to the extent which corresponds to the percentage of shares or interests of the SPE held by the fund.

Prevention of abuse

8. To reduce the risk of tax abuses by onshore businesses repackaging themselves as funds, it is proposed that a business undertaking for general commercial or industrial purpose is not a fund. Nevertheless, a fund's engagement in "qualifying transactions" will not be regarded as a business undertaking for general commercial or industrial purpose.

9. To prevent abuse or round-tripping by a resident person disguising as a fund to take advantage of the exemption, it is proposed that a resident person who, either alone or jointly with his associates, has a beneficial interest of

⁴ A "specified person" is currently defined in the Inland Revenue Ordinance (Cap. 112) ("IRO") as a corporation licensed under Part V of the Securities and Futures Ordinance (Cap. 571) ("SFO") to carry on, or an authorized financial institution registered under that Part for carrying on, a business in any regulated activity as defined by Part 1 of Schedule 5 to SFO.

⁵ A "qualifying fund" is currently defined in IRO as a fund with at least five investors; the capital commitments to the fund made by the investors should exceed 90% of the aggregate capital commitments; and the distribution of the net proceeds of the fund to the originator and its associates should not exceed 30%.

⁶ As OFCs are subject to the regulation of the Securities and Futures Commission (including the 10% de minimis limit based on gross asset value which allows flexibility for them to invest in non-qualifying assets) on an ongoing basis, they can enjoy profits tax exemption on transactions in non-qualifying assets as well.

30% or more in a tax-exempt fund (or any percentage if the fund is the resident person's associate) will be deemed to have derived assessable profits in respect of the trading profits earned by the fund from the qualifying transactions (i.e. the current anti-round tripping provisions in IRO will be maintained).

Requirements for investment in private companies

10. In order to reduce the risk of tax evasion by funds through their investment in private companies, it is proposed that a fund will be taxed on its profits from such investment that do not meet the following three tests –

- (a) immovable property test: if a fund invests in a private company that holds, whether directly or indirectly, more than 10% of its assets in immovable property (excluding infrastructure) in Hong Kong, the fund will be taxed on the profits arising from such an investment in the private company;
- (b) holding period test: if the private company (i) does not hold, whether directly or indirectly, any immovable property in Hong Kong; or (ii) holds, whether directly or indirectly, not more than 10% of its assets in immovable property in Hong Kong, and the investment in the private company has been held by the fund for at least two years, the fund will not be taxed on the profits arising from the transaction of the private company;
- (c) short-term asset test: if the holding period test at (b) above cannot be satisfied, profits tax exemption would only be provided if (i) the fund does not have a controlling stake in the private company; or (ii) the fund has a controlling stake in the private company, but the latter does not hold more than 50% of the value of the company's assets in short-term assets.⁷

Arrangements relating to open-ended fund companies and remuneration of investment managers

11. To ensure that there is a level playing field and avoid market confusion, the Bill also seeks to make suitable amendments to the existing provisions in IRO to align the profits tax treatment for OFCs with other funds.

⁷ Short-term assets are assets (excluding qualifying assets and immovable property in Hong Kong) held by the private company for less than three years at the time of the transaction.

12. The current principles that remuneration received by investment managers in respect of their professional services provided in Hong Kong will be subject to taxation will remain unchanged.

13. Details of the main provisions of the Bill are set out in paragraph 19 of the LegCo Brief (File Ref: ASST/3/1/5C (2018) Pt.19 dated 5 December 2018), and paragraphs 5 to 14 of the Legal Service Division Report on the Bill (LC Paper No. LS30/18-19). The Bill, if passed, would come into operation on 1 April 2019.

Major views and concerns expressed by Members

14. At the meeting on 5 November 2018, the Administration briefed the FA Panel on the proposed amendments to IRO to provide profits tax exemption for eligible funds operating in Hong Kong. The major views expressed by members are summarized in the ensuing paragraphs.

15. Members supported the legislative proposal in principle. Some members considered that the existing tax regimes for offshore funds was not conducive to local enterprises in raising funds from the domestic market as only offshore funds, but not onshore funds, might enjoy profits tax exemption. These members pointed out that, at the investment level, offshore funds could not invest in local private companies if they wished to enjoy profits tax exemption. Some other members were of the view that in addition to engaging the fund industry, the Administration should conduct a public consultation to gauge views from relevant stakeholders, in particular the business and technology sectors and investees like start-up companies, on the proposed tax concession arrangements.

16. The Administration advised that the legislative proposal sought to address EU's concern about ring-fencing on one hand, and enhance the competitiveness of the asset and wealth management sector on the other. The Administration had conducted a four-week industry consultation to gauge views of the fund industry on the preliminary proposal and had taken into account the industry's feedback in arriving at the current proposal.

17. Members sought clarification on whether a private company whose main business was securities trading could take advantage of profits tax exemption by repackaging itself as an onshore fund and whether the proposed profits tax exemption would be provided to funds investing in private companies with sales and leasing of real estate properties as their core business.

18. The Administration said that in order to reduce the risk of tax evasion by onshore businesses disguising themselves as funds, certain conditions would be imposed on a fund's investment in private companies, including the holding of immovable property in Hong Kong and short-term assets by the investee private companies. In general, if an investee private company held not more than 10% of its assets in immovable property in Hong Kong, and the investment in the private company had been held by the fund for at least two years, the fund would not be taxed on the profits arising from the transactions in securities of the private company. Moreover, in order to qualify for profits tax exemption, a fund which had not engaged a specified person should have at least five investors, and the fund's originator or the originator's associates would not be regarded as investors of the fund concerned. As regards the sales and leasing of real estate properties, the Administration clarified that a fund's direct investment in real estate properties would be subject to tax. Meanwhile, a private company which held properties and received investment from a fund would still be required to pay profits tax generated from profits deriving from the sales or letting of the properties held.

19. Members also sought information on the estimated tax revenue foregone resulting from the implementation of the legislative proposal. The Administration explained that the proposal should not give rise to significant revenue loss compared to the current regimes. This was because the majority of funds operating in Hong Kong were offshore ones and were already enjoying tax exemption under the current tax regimes.

Latest development

20. At the House Committee meeting on 14 December 2018, Members agreed to form a Bills Committee to study the Bill.

Relevant papers

21. A list of relevant papers is set out in the **Appendix**.

Appendix

List of relevant papers

Date	Event	Paper
5 November 2018	Meeting of the FA Panel	Administration's paper (LC Paper No. CB(1)101/18-19(04))
12 December 2018	The Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018 was introduced into the Legislative Council	The Bill Legislative Council Brief (File Ref: ASST/3/1/5C (2018) Pt.19) Legal Service Division Report (LC Paper No. LS30/18-19)