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

Government's responses to written submissions

This paper sets out the Government's response to the submissions to the Bills Committee on Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018 ("the Bill").

2. The purpose of the Bill is to address the concerns of the European Union over the ring-fencing features of Hong Kong's tax regimes for offshore privately offered funds[1] and to create a level playing field for both onshore and offshore funds operating in Hong Kong. In doing so, we have preserved the tax treatment already applicable to offshore funds as far as possible to avoid inadvertent disruption to market operation. Indeed, the proposed sections 20AN to 20AY and Schedules 15C, 15D and 16C are the same/largely modelled on the existing provisions relating to the tax treatment for offshore funds and open-ended fund companies ("OFCs") under the Inland Revenue Ordinance (Cap. 112) ("IRO").

3. We note that the industry has indicated its general support for the Bill which provides profits tax exemption for onshore and offshore funds operating in Hong Kong, regardless of their structure[2], their size or the purpose that they serve subject to meeting certain conditions. As for the further key technical comments relating to the Bill raised in the submissions, the Government's responses are summarised in paragraphs 5 to 17 below. For ease of reference, our responses are organised according to the proposed sections of the Bill.

4. Taking into account comments from the industry during our consultation in April/May 2018, we have put in new and self-contained provisions on the tax treatment for funds whilst leaving intact other features under our existing tax regimes that are not related to fund entities per se. We should also emphasise that the Inland Revenue Department ("IRD") will examine the totality of facts (including the fund constitutive documents,

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[1] There are no tax disparity issue and ring-fencing concerns in relation to publicly offered funds. Such funds can already enjoy profits tax exemption under section 26(1A) of the IRO. The current legislative exercise is on privately offered funds only.

[2] For example, unit trust, corporate or limited partnership structure.

investment mandates, rights and obligations of the investment manager, etc.) for each case to determine whether an arrangement fulfils the requirements as set out in the Bill and hence can enjoy the profits tax exemption.

Clause 1 – Commencement of the Bill

5. As stated in the Bill, the Bill will come into operation on 1 April 2019. An arrangement which can fulfil the requirements as set out in the Bill can enjoy the profits tax exemption from that day onwards. Before that day, a fund may enjoy profits tax exemption if it can fulfill the requirements under section 20AC (for offshore funds), section 20AH (for OFCs), or section 26A(1A) (for publicly offered funds).

Section 20AM – Definition of "fund"

6. According to the Bill, arrangements fulfilling the definition of "fund" under the proposed section 20AM and meeting the relevant conditions (such as those under the proposed section 20AN) would be eligible for profits tax exemption under section 20AN. As we understand it, the proposed definition of "fund" should be wide enough so that it should be able to capture different kinds of bona fide funds in operation, including pension funds. Also, our understanding is that most pension funds (both onshore and offshore) are publicly offered funds which can enjoy profits tax exemption under section 26A(1A). Meanwhile, there are some comments about the proposed section 20AM(5). We wish to clarify that this section is to: (a) exclude investment arrangements restricted to a group of companies; and (b) prevent turning taxable remuneration/benefits of employees (e.g. share option scheme, share award scheme, profit-sharing plan, post-employment benefit arrangement and termination benefit arrangement) into tax-exempted income through a fund structure.

7. Separately, according to section 7(2) of the Interpretation and General Clauses Ordinance (Cap. 1), the plural includes the singular. "Participating persons" in the proposed section 20AM(2) can accordingly be read as a "participating person". Reading this together with the proposed section 20AN(3)(a), and subject to meeting the relevant conditions (such as those under the rest of the proposed section 20AN), an arrangement may qualify for tax exemption as a fund even though it has one investor at a certain point in time

during the year of assessment.

8. The proposed sections 20AM(6) and (7) are to put it beyond doubt that a fund itself should not be directly undertaking any trading or business activities for general commercial or industrial purposes. A business undertaking would include one that directly engages in a commercial or an industrial activity including but not limited to those mentioned in the proposed section 20AM(7).

Section 20AN and section 20AO – Tax exemption for funds and for "special purpose entity" ("SPE")

9. As in the existing section 20AC(1)(b), incidental transactions are defined under the proposed section 20AN(2)(b) as transactions incidental to the carrying out of qualifying transactions. Also, the tax treatment for such transactions as set out in the proposed section 20AN(4) is modelled on the existing treatment as set out in the existing section 20AC(4)[3]. Meanwhile, the list of qualifying assets is set out in the proposed Schedule 16C[4]. This schedule covers those assets currently qualified for tax exemption for offshore funds and OFCs (i.e. Schedules 16 and 16A).

10. Similarly, the definition of SPE under the proposed section 20AO(4) is the same as the definition of "special purpose vehicle" under the current section 20ACA(2). This definition was added by the Inland Revenue (Amendment) (No. 2) Ordinance 2015 (Ord. No. 13 of 2015) to provide profits tax exemption for offshore private equity funds having considered their practice to invest in private companies through investment vehicles. We consider it not appropriate to extend the scope of profits tax exemption for an SPE at this juncture.

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[3] Interest income derived from debt instruments would be treated as transactions incidental to the carrying out of qualifying transactions since the payment of interest to holders of the debt instrument merely gives effect to the rights already attached to the debt instrument. The trading receipts from incidental transactions will be exempted from profits tax, subject to a 5% limit on the total trading receipts as set out in the proposed section 20AN(4). The above tax treatment is the same as set out in the current section 20AC(4). In response to comments that interest income arising from fixed-income/debt instrument by funds should also be exempted from payment of profits tax, the Government is of the view that the suggestion would have wide implications on Hong Kong's tax policy and is outside the scope of the Bill.

[4] Interest in a "partnership" or a "trust", which is a collective investment scheme, would fall within the definition of "securities" in Part 2 of the proposed Schedule 16C and is hence a type of qualifying asset.

11. In response to comments that the definition of SPE under the proposed section 20AO should be further relaxed to enable such entities to engage in other fund investment activities, the Government's view is that an SPE should be established solely for the purpose of holding and administering investee private companies, and should not engage in the other businesses (including managing the businesses of the private companies concerned). This is because if the definition of SPE is too wide, investee private companies engaging in direct business undertakings and held by a fund may be regarded as SPEs and inadvertently covered by the profits tax exemption. This would deviate from the intended purpose that an SPE should serve.

12. Moreover, if a fund/an SPE sells its investment in the unlisted securities through an initial public offering, it will continue to be eligible for profits tax exemption in respect of the divestment if the exemption conditions remain satisfied. The tax treatment of such investment has been explained in paragraph 53 of the IRD's Departmental Interpretation and Practice Notes No. 51.

Sections 20AP and 20AQ – Requirements for investment in private companies

13. The immovable property test, holding period test and short-term asset test as set out in the proposed sections 20AP and 20AQ aim to reduce the risk of tax evasion by funds through their investments in private companies. The immovable property test and short-term asset test are not new. They have been incorporated in the tax exemption regime for OFCs. In response to comments that the short-term asset test should only include those short-term assets in Hong Kong, we must point out that the test is only applicable to investments in an investee private company with a holding period of less than two years where the fund also has a controlling stake in the investee private company concerned. As the short-term asset test aims to reduce the risk of tax abuse by engaging in trading activities (i.e. transacting in trading assets) through sales of shares in private companies, the short-term assets do not limit to those assets held in Hong Kong.

Section 20AR – Tax treatment of co-investment of partner funds of the Innovation and Technology Venture Fund ("ITVF") Scheme

14. We have retained in the Bill the same tax treatment for such co-investment. And, the Bill does not prevent the use of an SPE in a co-investment by a partner fund of the ITVF Scheme. A partner fund, subject to meeting the relevant conditions, may enjoy tax exemption for the co-investment without the need to meet the three tests under the proposed sections 20AP and 20AQ.

Section 20AS - Circumstances whereby profits tax exemption does not apply to OFCs

15. As a principle, the profits of an OFC (or of other funds) arising from direct trading or direct business undertaking should be chargeable to profits tax. The tax treatment under the proposed section 20AS is the same as set out in the current section 20AH(7). Hence, while an OFC may enjoy profits tax exemption on transactions in non-qualifying assets pursuant to the proposed section 20AN, if an OFC engages in direct trading or direct business undertaking in Hong Kong in non-qualifying assets, or utilises non-qualifying assets to generate income, the aforementioned activities are still chargeable to profits tax. The above will not affect the eligibility for profits tax exemption in other qualified transactions.

Sections 20AU, 20AV, 20AX and 20AY - Loss sustained by funds and OFCs, and the anti-round tripping provisions

16. We have retained in the Bill the same treatment for the setting-off of losses by funds and OFCs. As a principle, loss sustained by a fund or an OFC in respect of its tax-exempted transactions (including incidental transactions) would not be available for set off against any of its assessable profits for the year of assessment or any subsequent year of assessment. Similarly, we have retained in the Bill the same anti-round tripping provisions applicable to funds to prevent tax leakage.

Others

17. We have considered the drafting suggestions in the submissions and consider the current drafting of the Bill should be sufficiently clear to implement the tax exemption treatment.

Financial Services and the Treasury Bureau
Inland Revenue Department
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