

立法會
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**Paper for the House Committee Meeting
on 14 December 2018**

**Legal Service Division Report on
Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018**

I. SUMMARY

- 1. The Bill**

The Bill seeks to amend the Inland Revenue Ordinance (Cap. 112) to allow profits tax exemption for certain funds whether or not the central management and control of the funds is exercised in Hong Kong; and to provide for related matters.
- 2. Public Consultation**

A four-week industry consultation on the preliminary proposal was conducted in April and May 2018. The financial services industry understood the need to remove ring-fencing features of the existing tax regimes but pointed out that the current tax treatment for offshore funds should be preserved as far as possible to avoid any inadvertent disruption to market operation. According to the Administration, the proposal in the Bill has taken into account the industry's feedback.
- 3. Consultation with LegCo Panel**

The Panel on Financial Affairs ("FA Panel") was briefed on 5 November 2018 by the Administration on the proposed amendments to Cap. 112. Members had no objection to the introduction of the Bill into the Legislative Council but raised various enquiries.
- 4. Conclusion**

The Legal Service Division is scrutinizing the legal and drafting aspects of the Bill. In view of the issues raised by members of the FA Panel, Members may consider whether a Bills Committee should be formed to study the Bill in detail.

II. REPORT

The date of First Reading of the Bill is 12 December 2018. Members may refer to the Legislative Council ("LegCo") Brief (File Ref.: ASST/3/1/5C (2018) Pt. 19) issued by the Financial Services and the Treasury Bureau on 5 December 2018 for further details.

Object of the Bill

2. The Bill seeks to amend the Inland Revenue Ordinance (Cap. 112) to allow profits tax exemption for certain funds whether or not the central management and control ("CMC") of the funds is exercised in Hong Kong; and to provide for related matters.

Background

3. Currently, profits tax exemption is given to publicly offered funds (irrespective of whether their CMC is located in or outside Hong Kong), and to offshore privately offered funds (i.e. with their CMC exercised outside Hong Kong) under Cap. 112. Except onshore privately offered open-ended fund companies ("OFCs")¹ which meet the conditions specified in section 20AH of Cap. 112, other onshore privately offered funds (i.e. with their CMC exercised in Hong Kong) currently cannot enjoy profits tax exemption under Cap. 112.

4. According to paragraphs 4 and 5 of the LegCo Brief, 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.² Hong Kong's tax regimes are considered harmful as Cap. 112 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. To further consolidate Hong Kong's competitive edge in the manufacturing and

¹ Under section 2(1) of Cap. 112, an open-ended fund company is defined to have the meaning given by section 112A of the Securities and Futures Ordinance (Cap. 571). Under section 112A of Cap. 571, an open-ended fund company is defined to mean a collective investment scheme constituted as a corporation that holds a certificate of incorporation issued by the Registrar of Companies under section 112C.

² 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.

management of funds and in order not to be put on the EU's list of non-cooperative jurisdictions for tax purposes, the Government announced in the 2018-19 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 the EU's concerns. The Bill is introduced into LegCo to provide profits tax exemption to eligible funds operating in Hong Kong following the review.

Provisions of the Bill

5. The main provisions of the Bill are summarized below.

Eligibility for profits tax exemption for funds regardless of location of central management and control

6. Clause 6 of the Bill, among others, seeks to add a new section 20AM to Cap. 112 to define the term "fund" to the effect that an entity meeting the new definition of "fund" ("qualified fund") would be eligible for profits tax exemption if the prescribed conditions in the proposed section 20AN are met regardless of its CMC location or its structure. Under the Bill, business undertakings for general commercial or industrial purposes would not be regarded as "funds" for the purposes of the proposed profits tax exemption. The meaning of "fund" as defined in the proposed section 20AM is similar (with necessary modifications) to that of "collective investment scheme" set out in section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571).

Exemption of certain profits of funds from payment of profits tax

7. Under the proposed section 20AN of Cap. 112, for a fund to be eligible for profits tax exemption in respect of assessable profits for a year of assessment, the following conditions have to be met:

- (a) the profits are earned from transactions in assets of a class specified in the proposed Schedule 16C ("qualifying transactions"), transactions incidental to the carrying out of qualifying transactions (subject to a 5% limit), and transactions in assets of a class that is not specified in the proposed Schedule 16C ("non-Schedule 16C class") if the qualified fund is an OFC;
- (b) the qualifying transactions are carried out in Hong Kong by or through specified persons which include corporations and authorized financial institutions licensed or registered under Cap. 571 to carry out such transactions; and

- (c) if the qualifying transactions are not carried out by or through specified persons, the fund is a qualified investment fund. A "qualified investment fund" is defined to mean a fund which at all times after the final closing of sale of interests (i) the number of investors exceeds four and (ii) the capital commitments made by investors exceed 90% of the aggregated capital commitments; and an agreement governing the operation of the fund provides that the originator and its associates would not receive more than 30% of the net proceeds arising out of the transactions after deducting the portion attributable to their capital contributions to the fund.

8. The proposed Schedule 16C to Cap. 112 seeks to set out the classes of assets specified for the qualifying transactions ("qualifying assets"), including shares, stocks, debentures, loan stocks, funds, bonds, or notes of, or issued by, a private company. The Commissioner of Inland Revenue may by notice published in the Gazette amend the proposed Schedule 16C. Such notice would be subsidiary legislation subject to the negative vetting procedure of LegCo.

Exemption of certain profits of special purpose entities from payment of profits tax

9. The proposed section 20AO seeks to exempt a special purpose entity (i.e. a legal entity that is wholly or partly owned by a qualified fund and is established solely for the purpose of holding and administering one or more investee private companies) ("SPE") from paying profits tax in relation to transactions in certain securities specified in the proposed section 20AO. The extent of exemption is proposed to be the percentage of the qualified fund's ownership of the SPE in the year of assessment.

Circumstances under which the proposed profits tax exemption would not apply

10. The proposed sections 20AP and 20AQ seek to set out the circumstances under which the profits tax exemption proposed in the new sections 20AN and 20AO would not apply to a qualified fund or SPE. These circumstances are set out below:

- (a) a qualified fund or SPE investing in a private company that holds, whether directly or indirectly, more than 10% of the value of its assets in immovable property in Hong Kong;
- (b) the qualified fund or SPE concerned holding its investment in the private company for less than two years where the aggregate value of the immovable property held by the private company does not exceed 10% of the value of its assets ("holding period test"); and

- (c) where the holding period test is not satisfied, the qualified fund or SPE having control over the private company or the private company concerned holding more than 50% of the value of the company's assets in short-term assets (i.e. assets, excluding qualifying assets and immovable property in Hong Kong, held by the company for less than three consecutive years before the date of disposal).

Arrangements relating to open-ended fund companies

11. The proposed section 20AS seeks to provide that an OFC would not be exempt from profits tax in respect of its assessable profits if it carries on a direct trading or direct business undertaking in Hong Kong in assets of a non-Schedule 16C class, or holds assets of a non-Schedule 16C class that are utilized to generate income.

12. If the instrument of incorporation of an OFC ("the main company") provides for the division of its scheme property (as defined by section 112A of Cap. 571) into separate parts (each of which is a sub-fund), under the proposed section 20AT, each sub-fund would be regarded as an OFC for computing the assessable profits of the sub-fund. The effect is that if the condition for profits tax exemption under the proposed section 20AN is met in respect of a sub-fund, the sub-fund would enjoy profits tax exemption even if the condition is not met in respect of another sub-fund of the main company.

Other amendments

13. The Bill seeks to repeal the existing sections 20AG to 20AL of Cap. 112, and Schedules 15B, 16A and 16B to Cap. 112 to align the profits tax treatment for OFCs with other funds.

14. The Bill also makes related and other textual amendments.

Commencement

15. The Bill, if passed, would come into operation on 1 April 2019.

Public Consultation

16. According to paragraph 25 of the LegCo Brief, the Administration conducted a four-week industry consultation on the preliminary proposal in April and May 2018. The financial services industry understood the need to remove ring-fencing features but pointed out that the current tax treatment for

offshore funds should be preserved as far as possible to avoid any inadvertent disruption to market operation. According to the Administration, the proposal in the Bill has taken into account the industry's feedback.

Consultation with LegCo Panel

17. As advised by the Clerk to the Panel on Financial Affairs ("FA Panel"), the FA Panel was briefed on 5 November 2018 on the proposed amendments to Cap. 112 to provide profits tax exemption for funds operating in Hong Kong regardless of the structure under which they were established or their location of CMC. Members had no objection to the introduction of the Bill into LegCo. They enquired about the Administration's measures to reduce the risk of tax abuses by onshore businesses repackaging themselves as funds, and called on the Administration to consult relevant stakeholders on the proposed tax concession arrangements, in particular the business and technology sectors and investees like start-up companies.

Conclusion

18. The Legal Service Division is scrutinizing the legal and drafting aspects of the Bill. In view of the above issues raised by members of the FA Panel, Members may consider whether a Bills Committee should be formed to study the Bill in detail.

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