

立法會
Legislative Council

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Paper for the House Committee meeting on 25 January 2019

**Report of the Bills Committee on
Inland Revenue (Profits Tax Exemption for Funds)
(Amendment) Bill 2018**

Purpose

This paper reports on the deliberations of the Bills Committee on Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018 ("the Bills Committee").

Background

2. At present, under the Inland Revenue Ordinance (Cap. 112), profits tax exemption is given to both onshore and offshore publicly offered funds.¹ For privately offered funds, only offshore privately offered funds and offshore private equity ("PE") funds (collectively known as "offshore funds" hereafter) enjoy profits tax exemption. Onshore privately offered funds, with the exception of open-ended fund companies ("OFCs"),² do not enjoy profits tax

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. Onshore privately offered OFCs can enjoy profits tax exemption since 30 July 2018 with the passage of the Inland Revenue (Amendment) (No.2) Ordinance 2018.

exemption.

3. The tax disparity is not considered conducive to the further development of Hong Kong's asset and wealth management industry. This is because tax disparity will disincentivize funds to domicile and/or be managed in Hong Kong. Furthermore, based on the latest Base Erosion and Profit Shifting standard of the Organisation for Economic Co-operation and Development, 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.³

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, following a review on the existing tax concession arrangements applicable to funds, proposes to introduce amendments to Cap. 112. The objective of the legislative amendments is to remove ring-fencing tax features for fund entities⁴ while leaving intact other features under the existing tax regimes that are not related to fund entities per se. The opportunity is also taken to adjust certain tax treatment for funds so that Hong Kong remains competitive in the face of increasing regional and international competition.

5. The Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018 ("the Bill") was gazetted on 7 December 2018, and received its First Reading at the Legislative Council meeting of 12 December 2018.

The Bill

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

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

7. Clause 6 of the Bill, among other matters, seeks to add a new section 20AM to Cap. 112 to define "fund" to the effect that an arrangement meeting the new definition of "fund" would be eligible for profits tax exemption

³ Ring-fencing occurs where the preferential tax treatment is partially or fully isolated from the domestic economy. It 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.

⁴ There are no tax disparity issue and ring-fencing concerns in relation to publicly offered funds. The current exercise is on privately offered funds only.

if the prescribed conditions under the Bill are met regardless of its location of central management and control 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.

Exemption of certain profits of funds from payment of profits tax

8. Under the proposed section 20AN of Cap. 112, a fund would be eligible for profits tax exemption in respect of assessable profits for a year of assessment if it meets the following conditions at all times during the basis period for the year of assessment:

- (a) the profits are earned from (i) transactions in assets of a class specified in the proposed Schedule 16C ("qualifying transactions"); (ii) transactions incidental to the carrying out of qualifying transactions (subject to a 5% limit); and (iii) transactions in assets of a class that is not specified in the proposed Schedule 16C ("non-Schedule 16C class") if the fund is an OFC; and
- (b) either (i) the qualifying transactions are carried out in Hong Kong by or through, or arranged in Hong Kong by specified persons which include corporations and authorized financial institutions licensed or registered under the Securities and Futures Ordinance (Cap. 571) to carry on a business in any regulated activity as defined under Cap. 571; or (ii) the fund is a qualified investment fund.⁵

9. 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.

⁵ A "qualified investment fund" is defined to mean a fund which (a) 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 (b) 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.

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

10. The proposed section 20AO seeks to exempt a special purpose entity⁶ ("SPE") from payment of profits tax in relation to transactions in certain securities specified in the proposed section 20AO(2)(a) to (c). The extent of exemption is proposed to be the percentage of the fund's ownership of SPE in the year of assessment.

Circumstances under which the proposed profits tax exemption would not apply

11. 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 transaction by a fund or SPE which carries out transactions in securities of, or issued by, a private company. These circumstances are set out below:

- (a) a fund or SPE investing in a relevant private company that holds, whether directly or indirectly, immovable property in Hong Kong or share capital in another private company holding immovable property in Hong Kong, the aggregate value of which exceeds 10% of the value of the relevant private company's assets ("immovable property test"); or
- (b) where the 10% threshold in the immovable property test is not exceeded, the fund or SPE concerned hold its investment in the relevant private company for less than two years ("holding period test"); and
 - (i) the fund or SPE have control over the private company; and
 - (ii) the relevant private company holds 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) ("short-term asset test").

⁶ A special purpose entity is a legal entity that is wholly or partly owned by a fund and is established solely for the purpose of holding and administering one or more investee private companies.

Tax treatments of open-ended fund companies

12. 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.

13. The proposed section 20AT seeks to provide that, 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), 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

14. 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.

The Bills Committee

15. At the House Committee meeting held on 14 December 2018, Members agreed to form a Bills Committee to scrutinize the Bill. Hon Kenneth LEUNG was elected Chairman of the Bills Committee. The membership list of the Bills Committee is in **Appendix I**.

16. The Bills Committee has held two meetings with the Administration and invited written views from the public and relevant organizations. A total of 11 written submissions on the Bill were received. A list of organizations which have provided written views to the Bills Committee is in **Appendix II**. The depositions are generally supportive of the direction of the Bill, and the comments mainly focus on certain technicalities and implementation details.⁷ The Administration has provided a written response to the issues raised in the depositions' submissions.⁸

⁷ The submissions can be found at https://www.legco.gov.hk/yr18-19/english/bc/bc06/papers/bc06_d.htm.

⁸ The Administration's response can be found at [LC Paper No. CB\(1\)472/18-19\(01\)](#).

Deliberations of the Bills Committee

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

Meaning of "fund"

18. According to the Administration, the definition of "fund" as set out in the proposed section 20AM of the Bill was drawn up taking into consideration the definition of "collective investment scheme" in Part 1 of Schedule 1 to Cap. 571, related provisions in Cap. 112 as well as the comments received from the industry during the consultation exercise. The proposed definition of "fund" in the proposed section 20AM should be wide enough to capture different kinds of bona fide funds in operation, regardless of their structure, their size or the purpose that they serve.

19. The Legal Adviser has pointed out that, according to the proposed section 20AM(6), a fund does not include a business undertaking for general commercial or industrial purposes that directly engages in certain commercial activities including those listed in the proposed section 20AM(7). He has queried, as the Bill is drafted, whether a fund investing in a private company which engages in one of the listed commercial activities, would be regarded as having "indirectly" engaged in those activities and would, as a consequence, not be eligible for tax exemption under the Bill. The Chairman has also queried whether an arrangement or a collective investment scheme would not be considered a fund if part of the investment is in immovable property, and would not be eligible for profits tax exemption under the Bill.

20. The Administration has explained that the Bill allows a fund to invest in local or overseas private companies that carry on a trade or business. Although the fund may be seen as being "indirectly" engaging in certain trading or business activities, the Administration considers such investment activities as part of the normal operation of a fund and would not affect the fund's eligibility for profits tax exemption under the Bill. The Administration also considers that, to avoid a fund meeting the definition of "fund" under the proposed section 20AM and engaging in bona fide investment activities being regarded as a business undertaking for general commercial or industrial purposes, it would not be appropriate to add "indirectly" in the proposed section 20AM(7).

21. The Chairman has queried whether a commercial co-investment contract under which contracting parties agree to participate in an investment would meet the definition of a "fund" under the Bill. The Administration has explained that the reference to "arrangement" in the definition of fund in the proposed section 20AM(2) encompasses the concept of contractual arrangements as well as legal arrangements in civil law jurisdictions. Therefore, a fund in the context of the Bill can be in the legal form of, for example, a partnership, a limited partnership, unit trust, OFCs, mutual fund corporation or contractual arrangement.

"No tainting" principle of the Bill

22. In addressing the Bill Committee's queries, the Administration has explained that the proposed tax-exemption measure will have no "tainting effect". After the Bill is passed, an arrangement which meets the definition of "fund" and fulfills the exemption conditions specified in the Bill (including the immovable property test, holding period test or the short-term asset test) would be eligible for profits tax exemption for its qualifying transactions (and for OFCs, the non-qualifying transactions). The tax-exempted profits of a fund will not be tainted even if the fund has other taxable transactions failing the exemption conditions specified in the Bill.

23. Due to price fluctuation, the value of immovable properties held by a private company may exceed 10% of its assets at one time and fall below 10% at another time during the year of assessment. Members have queried, where a fund invests in such private companies with immovable property assets, at which point in time would the immovable property test be applied to determine the fund's eligibility for tax exemption under the Bill, and whether the fund is responsible to keep track of the value and apply for tax exemption.

24. The Administration has explained that a snapshot of the private company's assets would be taken when the fund makes a transaction in the private company concerned. The eligibility for tax exemption would then be assessed according to the proportion of the immovable property's value over the private company's assets.

25. The Chairman has sought clarification from the Administration on whether a company which undertakes both commercial and investment activities may make use of the "no tainting" principle of the Bill and claim profits tax exemption in respect of the income derived from investment activities. The Administration has explained that a company must first satisfy the definition of "fund" under the Bill in order to qualify for profits tax exemption. A business undertaking for general commercial or industrial purposes which carries out commercial or industrial transactions would not meet this requirement.

Meaning of "non-resident person"

26. Section 20AC provides, among other matters, that a non-resident person who is a qualifying fund is exempt from tax in respect of his assessable profits from certain transactions. This section is amended so that on and after 1 April 2019, a reference to a non-resident person does not include a fund within the meaning of section 20AM. In response to a point of clarification from the Chairman, the Administration has advised that on and after 1 April 2019 (when the proposed profits tax exemption measures take effect), a "non-resident person" in Cap. 112 would cover non-resident non-fund entities, which include mainly non-resident individuals and non-resident enterprises without permanent establishment in Hong Kong, and non-resident enterprises and corporations which do not fall within the meaning of "fund" as defined in the proposed section 20AM. Provided that these entities continue to meet the exemption conditions under the amended section 20AC, they would continue to be entitled to profits tax exemption under that section after the passage of the Bill.

Conditions under which certain profits of funds are exempt from payment of tax

27. The Legal Adviser has pointed out that profits tax exemption is given to offshore privately offered funds under section 20AC of Cap. 112, and, subject to the passage of the Bill, will be available under the proposed section 20AN on and after 1 April 2019. As section 20AC remains effective, the Legal Adviser has queried whether there may be overlapping between in section 20AC and the proposed section 20AN in respect of tax exemption arrangements for offshore privately offered funds, and whether an offshore fund currently exempt from profits tax under section 20AC but cannot meet the definition of "fund" under the proposed section 20AM could continue to enjoy profits tax exemption under the former provision on and after 1 April 2019.

28. The Administration has advised that if the Bill is passed, an arrangement meeting the definition of "fund" under the proposed section 20AM would be eligible for profits tax exemption under the proposed section 20AN for any year of assessment commencing on and after 1 April 2019. A non-resident entity which does not meet the definition of "fund" under the proposed section 20AM but can satisfy the exemption conditions under section 20AC could continue to enjoy tax exemption under that section. The Administration has advised that there should not be any overlapping between section 20AC and the proposed section 20AN.

29. In response to the Chairman's query, the Administration has clarified that a fund which does not engage a specified person (cf. paragraph 8(b)(i) above) to arrange or carry out its transactions would need to satisfy the

conditions of a "qualified investment fund" at all times during the year of assessment in order to qualify for the tax exemption under the Bill.

Tax exemption requirements for open-ended fund companies

30. The Bills Committee notes that at present, section 20AH(2)(b) of Cap. 112 provides that an OFC must be non-closely held in order for it to be eligible for profits tax exemption. The purpose of the "non-closely held" requirement is to ensure that an OFC enjoying tax exemption is not owned by a few individuals or corporate investors only, and to prevent an individual or a corporate investor to abuse the tax exemption by repackaging its business as an OFC. The Legal Adviser has pointed out that the "non-closely held" requirement will be removed by the amendments under clause 5 but is not reinstated elsewhere in the Bill. The Legal Adviser has queried the reason for not retaining the "non-closely held" requirement in the Bill and, without the requirement, how the Bill would address the previous concerns that section 20AH seeks to cover.

31. The Administration has explained that the conditions for OFCs to be eligible for profits tax exemption should basically be the same as those for the other funds so that there is a level playing field for funds operating in Hong Kong. All funds, including OFCs, are required to (a) engage a specified person to arrange or carry out its transactions in Hong Kong (cf. paragraph 8(b)(i) above), or (b) be a qualified investment fund (cf. paragraph 8(b)(ii) above) in order to enjoy profits tax exemption under the proposed section 20AN. These conditions would replace the "non-closely held" requirement.

32. In response to the Chairman's query, the Administration has explained that an OFC is currently eligible for profits tax exemption in respect of transactions in assets of a non-Schedule 16C class under the current section 20AH. OFCs are regulated by the Securities and Futures Commission ("SFC") and at least 90% of their investments are required to be securities or related products. The Administration considers that, as OFCs are already subject to stringent regulation of SFC, OFCs should continue to enjoy profits tax exemption on a wider range of transactions.

33. The Bills Committees notes that, for an OFC, profits earned from transactions in assets of a non-Schedule 16C class could enjoy profits tax exemption under the proposed section 20AN. Under the proposed section 20AS, an OFC would not be entitled to the profits tax exemption 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. The Legal Adviser has raised the queries on the circumstances under which an OFC would be regarded as carrying on a direct

trading or direct business undertaking in Hong Kong in assets of a non-Schedule 16C class, or holding such assets to generate income, and whether such circumstances should be set out in the Bill.

34. The Administration has responded that as a matter of 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 that set out in the current section 20AH(7). Despite the fact that an OFC may enjoy profits tax exemption on transactions in assets of a non-Schedule 16C class pursuant to the proposed section 20AN, if an OFC engages in direct trading or direct business undertaking in Hong Kong in assets of a non-Schedule 16C class, or utilizes such assets to generate income, such activities are still chargeable to profits tax.

35. The Administration has also pointed out that the operations of each OFC differ, and that it would be difficult to specify the types of assets of a non-Schedule 16C class which OFCs would invest in, and how these assets would be used for direct trading or direct business undertaking. Against these considerations, the Administration informs the Bills Committee that it appears not appropriate to set out such circumstances in the Bill. After the Bill is passed, the Inland Revenue Department ("IRD") will issue a Departmental Interpretation and Practice Note ("DIPN") which will cover the interpretation and practice relating to the Bill as a whole. Two existing DIPNs will be amended to make it clear that section 20AC will not be applicable to funds within the meaning of section 20AM on and after 1 April 2019. The Administration has supplemented that DIPNs are now under preparation and may seek views from the relevant stakeholders during the process, if necessary.

Circumstances under which a fund or special purpose entity may enjoy tax exemption if certain conditions are met in good faith

36. The Bills Committee notes that the proposed sections 20AP and 20AQ seek to set out the circumstances under which profits tax exemption under the proposed sections 20AN and 20AO would not apply to a fund or a SPE. Under the proposed sections 20AP(2) and 20AQ(2), profits tax exemption would still be granted to a fund or a SPE if a condition specified in the proposed section 20AP(3) or 20AQ(3) is met "in good faith". The Administration has explained that the phrase "in good faith" is intended to guard against notional but not genuine compliance of the requirement. Similar wording can be found in other provisions of Cap. 112, such as section 26A(1A)(a)(ii) (relating to profits tax exemption for publicly offered funds) and section 14G(1) (relating to profits tax concessions to qualifying aircraft lessors and qualifying aircraft leasing managers). IRD will take into consideration all relevant factors in determining whether a fund or a SPE is acting in good faith.

Assessable profits of funds or special purpose entities regarded as assessable profits of resident persons

37. The Administration has explained that the proposed sections 20AX and 20AY specify the circumstances under which the assessable profits of a fund or a SPE would be regarded as the assessable profits arising in, or derived from, Hong Kong of a resident person for the year of assessment from a trade, profession or business carried on by the resident person in Hong Kong. These circumstances include where a resident person holds not less than 30% of beneficial interests in the fund. The Chairman has asked which party would be responsible to make a declaration of the details of the ownership interest. The Administration has clarified that it would be for the resident person to make a declaration in a tax return if he holds not less than 30% of beneficial interests in the fund.

Certificates of deposit

38. The Bills Committee has enquired whether "certificates of deposit" as listed in Part 1 of the proposed Schedule 16C are restricted to those issued by banks and would not include debts, long term bonds or loan securities issued by financial institutions or corporations, which are sometimes also distributed as "certificates of deposit". The Administration has advised that the certificates of deposit mentioned in the proposed Schedule 16C are defined by Part 1 of Schedule 1 to Cap. 571 and would cover a wider range of products than those issued by banks. However, the Administration has supplemented that financing products are subject to other regulations and are unlikely to be covered under the proposed Schedule 16C.

Anti-tax avoidance measures

39. The Bills Committee notes that under the anti-tax avoidance measures in the Bill, a fund would be taxed on its profits from investment in private companies that do not meet the immovable property test, holding period test and the short-term asset test.⁹ The Administration has explained that the immovable property test is introduced to discourage funds from investing excessively in the local immovable property market. The holding period test and the short-term asset test are targeted at encouraging funds to focus on the long-term prospects of the investee private companies. The short-term asset test also 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.

⁹ A summary of the three tests is given in paragraph 12 of [Legislative Council Brief on Inland Revenue \(Profits Tax Exemption for Funds\) \(Amendment\) Bill 2018](#).

40. In addressing members' queries, the Administration has supplemented that, the immovable property test and the short-term asset test are not new. The same thresholds are used in the existing profits tax exemption regime for OFCs. The two-year period under the holding period test was drawn up having regard to the information gathered from the PE fund industry in the earlier industry consultation exercise. The Administration has advised that according to the industry statistics, around 85% of the investments made by PE funds are held for two years or more.

Economic benefits of the proposed profits tax exemption

41. Some members have asked whether the Administration has estimated the potential impact on investment in local businesses as a result of the proposed profits tax exemption for funds under the Bill. Members have suggested that the Administration should publish annual data on the fund industry's investment in local businesses, in order to track and quantify the impact of the Bill. The Administration has responded that there are no statistics to support an assessment at this stage, but the proposed tax exemption measure should remove the tax disincentive for funds to invest in Hong Kong's private companies. The Administration has also informed the Bills Committee that it may consider how best to assess the reception and impact of the Bill following its implementation.

Consultation with the industry

42. The Administration has informed the Bills Committee that an industry consultation was conducted in April and May 2018 with relevant stakeholders, including the fund sector, major accounting firms and relevant professional bodies. No objections were received on the direction of the Bill, and the Administration has addressed the issues raised by the sector through an interactive process. The Administration has affirmed that it has carefully considered the comments and incorporated the sector's views where appropriate into the current Bill.

Other legal and drafting issues

43. The Bills Committee has examined the Bill clause by clause and has noted the legal and drafting issues raised by the Legal Adviser to the Bills Committee¹⁰ and the Administration's responses on the issues.¹¹

¹⁰ Issued vide [LC Paper No. CB\(1\)414/18-19\(03\)](#) on 5 January 2019.

¹¹ Issued vide [LC Paper No. CB\(1\)423/18-19\(01\)](#) on 7 January 2019.

Proposed amendments to the Bill

44. Neither the Bills Committee nor the Administration intends to propose amendments to the Bill.

Resumption of the Second Reading debate on the Bill

45. The Bills Committee supports the resumption of the Second Reading debate on the Bill at the Council meeting of 20 February 2019.

Advice sought

46. Members are invited to note the deliberations of the Bills Committee.

Council Business Division 1
Legislative Council Secretariat
24 January 2019

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

Membership List

Chairman

Hon Kenneth LEUNG

Members

Hon James TO Kun-sun

Hon WONG Ting-kwong, GBS, JP

Hon Charles Peter MOK, JP

Hon Christopher CHEUNG Wah-fung, SBS, JP

Hon CHUNG Kwok-pan

Hon CHAN Chun-ying, JP

Hon CHEUNG Kwok-kwan, JP

(Total : 8 members)

Clerk

Mr Daniel SIN

Legal Adviser

Mr Alvin CHUI

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

List of organizations which has provided written submissions

1. The Hong Kong Institute of Chartered Secretaries
2. Hong Kong Trustees' Association
3. Hong Kong Venture Capital and Private Equity Association
4. Alternative Investment Management Association
5. Asia Securities Industry and Financial Markets Association
6. PricewaterhouseCoopers Limited
7. Deloitte Advisory (Hong Kong) Limited
8. Hong Kong Institute of Certified Public Accountants
9. KPMG Tax Services Limited
10. Ernst & Young Tax Services Limited
11. The Hong Kong Society of financial Analysts