

**For discussion on  
4 April 2005**

**Legislative Council Panel on Financial Affairs**

**Legislative Proposal to Provide Profits Tax Exemption  
to Offshore Funds**

**PURPOSE**

This paper sets out the Administration's proposal for implementing the profits tax exemption for offshore funds. Members are invited to offer their views on the proposal.

**BACKGROUND**

**Objective of the Proposal**

2. The financial services industry is playing an increasingly important role in our economy, contributing to over 13% of our GDP. It is of supreme importance that we must maintain and further strengthen our competitiveness as an international financial centre (IFC). Hong Kong is facing keen competition from other major IFCs. In terms of tax treatment for offshore funds, major financial centres including New York and London as well as our major competitor in Asia, Singapore, all exempt offshore funds from taxation.

3. To reinforce the status of Hong Kong as an IFC, the Government proposed in the 2003-04 Budget to exempt offshore funds from profits tax. The proposal would help to attract new offshore funds to Hong Kong and to encourage existing offshore funds to continue to invest in Hong Kong. Anchoring offshore funds in Hong Kong markets could also help maintain international expertise, promote new products, and

encourage investments in the local fund management industry.

### **Existing provisions**

4. Under section 14 of the Inland Revenue Ordinance (IRO), a person carrying on a trade, profession or business in Hong Kong is chargeable to profits tax in respect of assessable profits arising in or derived from that trade, profession or business. This requirement has no regard to the residency of the person.

5. Where a person is a non-resident and the business is carried on through an agent, section 20A of the IRO provides that the non-resident can be charged to tax in the name of the agent and the tax can be recovered from the agent unless the agent is relieved from such liability under section 20AA of the IRO. However, this section does not exempt any possible profits tax liability of the non-resident clients themselves.

6. Certain specified investment funds are currently exempt from profits tax under the IRO. These include mutual funds, unit trusts and similar investment schemes authorised under the Securities and Futures Ordinance (Cap. 571) (SFO) or where the Commissioner of Inland Revenue is satisfied that they are bona fide widely held investment schemes which comply with the requirements of a supervisory authority within an acceptable regime.

7. The profits of offshore mutual funds, unit trusts and other similar investment schemes which are not “bona fide widely held” or do not comply with “the requirements of supervisory authorities within acceptable regulatory regimes” are not exempt under section 26A(1A). Quite a number of offshore funds fall within this category and therefore cannot enjoy exemption. These funds represent an important part of the Hong Kong fund industry and contribute considerably to the financial services sector at large.

## **THE PROPOSAL**

8. The Administration has conducted two rounds of consultation on the approach for effecting the proposed profits tax exemption for offshore funds. Taking into account the views gathered, we propose to introduce two sets of provisions to the Inland Revenue Ordinance - the Exemption Provisions and the Deeming Provisions.

### ***The Exemption Provisions***

9. To qualify for the proposed exemption, the following conditions have to be met:

- (i) The profits are derived from securities trading transactions undertaken in Hong Kong by non-resident entities, including individuals, partnerships, trustees and corporations;
- (ii) The scope of “securities trading transactions” covers dealings in securities, futures contracts, foreign exchange trading, trading through automated trading services and asset management as defined as Type 1, 2, 3, 7 and 9 Regulated Activities in Schedule 5 of the Securities and Futures Ordinance;
- (iii) The securities trading transactions must be carried out by a broker or an approved investment adviser who meets the condition under section 20AA of the IRO. We also propose to dispense with the existing “associate” test and “independent” test in section 20AA of the IRO, which seek to restrict the relief enjoyed by investment advisors/brokers from the tax liability of their non-resident clients<sup>1</sup>; and
- (iv) The non-resident entities must not carry on any other business in Hong Kong. In view of the fact that it is not unusual for offshore funds to undertake activities incidental to the exempted

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<sup>1</sup> Section 20A of the IRO provides that a non-resident carrying on business through an agent can be charged to tax in the name of the agent and that the tax can be recovered from the agent, unless the agent is relieved from such a requirement under section 20AA. To qualify for the relief, certain conditions must be satisfied. These include that the brokers/approved investment advisers must not be the associates of the non-resident clients (the “associate” test) and must be independent from the non-resident clients (the “independent” test).

business, we propose that non-residents deriving income incidental to the exempted business in Hong Kong will not be regarded as carrying on other business in Hong Kong (thus being disqualified from the exemption). However, exemption for such incidental income will be subject to a de minimis rule (i.e. not exceeding 5% of the total income).

### ***The Deeming Provisions***

10. To implement the exemption, there is a need to put in specific anti-avoidance provisions to prevent abuse or round-tripping by local funds and other entities disguised as offshore funds or other entities to take advantage of the exemption. We propose to put in deeming provisions, which would deem a resident holding a beneficial interest in a tax-exempt non-resident to have derived assessable profits in respect of profits earned by the non-resident from exempted securities trading transactions in Hong Kong. The amount of the deemed assessable profits would be ascertained by taking into account the percentage of the resident's beneficial interest and the length of ownership within the basis period of the relevant year of assessment, irrespective of whether the profits have been distributed to the resident. The resident beneficial owner would have the duty to report the deemed assessable profits to the IRD.

11. We also propose to restrict the application of the deeming provisions to the following situations-

- (a) funds that are not bona fide widely held. (At present, an offshore fund must be both bona fide widely held AND authorized by a supervisory authority within an acceptable regime in order to enjoy tax exemption. We now propose to apply the deeming provisions to funds that are not bona fide widely held as we consider that it would be unlikely for a resident to carry out round-tripping transactions through holding interests in a fund that is bona fide widely held, though not authorized.)

- (b) a resident, alone or with his associates, whether resident or non-resident, directly or indirectly holds 30% or more of the beneficial interest in a tax-exempt non-resident entity. In the consultation paper for the second round of consultation, we proposed a threshold of 30%. A threshold is provided on the basis that a resident with such a significant holding in a non-resident entity should not have difficulty in obtaining information from that entity on the latter's assessable profits from exempted business in Hong Kong for the purposes of reporting deemed assessable profits to the IRD. Quite a number of respondents considered that the threshold should be increased to 50%. Members are invited to comment on whether the threshold should be increased from 30% to 50%; and
  
- (c) a resident directly or indirectly holds any percentage of the beneficial interest in a tax-exempt non-resident entity which is his associate. The resident should have no difficulty in obtaining information from his associate non-resident under such scenario.

### *Effective Dates*

12. We propose that the Exemption Provisions should apply with retrospective effect to the year of assessment commencing on 1 April 1996, in order to put beyond doubt that such profits are exempted from profits tax, and that the deeming provisions should take effect upon enactment of the Bill in view of the possible difficulties for resident persons to obtain information in respect of their interests in non-resident persons in past years.

### **PUBLIC CONSULTATION**

13. The Administration has conducted two rounds of consultation with the industry and interested parties in early 2004 and early 2005 respectively on the approach for effecting the proposed profits tax exemption for offshore funds. A total of 22 submissions were received

in the latest consultation exercise. Deputations generally consider that the Administration's proposed approach which is set out in paragraphs 8 to 12 above is the correct approach.

14. The main requests by deputations include the following: the scope of exemption should cover income derived from dealings in futures contracts, leveraged foreign exchange trading as well as incidental income; the "associate" and "independent" tests in section 20AA should be removed such that offshore funds engaging in securities trading transactions through associated or non-independent investment advisors/brokers could also enjoy exemption; the exemption should take retrospective effect, etc. On these aspects, the Administration has reviewed our original proposals and taken on board the deputations' suggestions as set out above. Other suggestions include, as mentioned in paragraph 11(b) above, increasing the exemption threshold for the deeming provisions from the originally proposed 30% to 50%; and even doing away with the deeming provisions proposal altogether. Some respondents expressed the views that the deeming provisions in the proposal would inevitably lead to more administrative workload for the fund managers and relevant financial intermediaries and some resident investors might perceive their position to be worse off, as the onus would be placed on them to report the deemed assessable profits to the IRD. Nevertheless, we consider it necessary to adopt the deeming provisions to avoid abuse.

## **IMPACT OF THE PROPOSAL**

15. If the proposals in paragraphs 8 to 12 above are implemented, Hong Kong's tax treatment for offshore funds will be more favourable than other IFCs such as US, UK and Singapore. Singapore imposes a 20% threshold on the resident interest in the offshore funds in order for the fund to qualify for exemption whereas both US and UK do not impose such threshold requirements. All three jurisdictions impose tax on income received by resident investors from offshore funds regardless of the percentage of beneficial interest held in the offshore funds and the locations where the income is derived.

16. There are comments from some of the respondents that the proposed exemption would put onshore funds in a less favourable position. We have considered this issue carefully. As mentioned in paragraph 5 above, mutual funds, unit trusts and similar investment schemes authorised under the Securities and Futures Ordinance (Cap. 571) (SFO) are already exempt from profits tax. Onshore funds that are not exempted mainly include those institutional funds and corporate or private client portfolios that are not offered to the public and thus do not require authorization from the SFC. We have also looked at the tax treatment of incomes derived from onshore funds in other IFCs such as UK and Singapore. Hong Kong compares favourably with these jurisdictions in which the investment incomes of residents are generally liable to income tax. According to practices in other major financial centres, preferential tax treatment is usually made available only to public funds that are widely held, but rarely to privately held funds. The existing practice in Hong Kong is therefore in line with international practices.

## **FINANCIAL IMPLICATIONS**

17. Due to difficulties in obtaining details of transactions involving non-resident persons, the Inland Revenue Department (IRD) is not in a position to enforce the relevant provisions effectively in practice in respect of cases where the persons carrying on the business are non-residents. Thus, the cost to revenue of this proposal should not be significant.

## **PROPOSED LEGISLATIVE AMENDMENTS**

18. We propose to amend the IRO to implement the proposal in paragraphs 8 to 12 above.

19. Our intention is to submit the relevant Bill to this Council in the current legislative year.

**ADVICE SOUGHT**

20. Members are invited to note the Administration's proposal to implement the profits tax exemption for offshore funds and provide comments on the proposal.

Financial Services and the Treasury Bureau  
March 2005