

**CONSULTATION PAPER ON
EXEMPTION OF OFFSHORE FUNDS FROM PROFITS TAX**

FINANCIAL SERVICES AND THE TREASURY BUREAU

JANUARY 2004

1. The Financial Services and the Treasury Bureau (FSTB) invites public comments on the proposals in this consultation paper.
2. The consultation paper can also be found on the website of FSTB at <http://www.info.gov.hk/fstb>.
3. Members of the public are invited to send their views in writing on or before 13 February 2004 –

By mail to Financial Services Branch
 Financial Services and the Treasury Bureau
 18/F Admiralty Centre Tower I
 18 Harcourt Road
 Admiralty
 Hong Kong
 (Attn.: Consultation on Exemption of Offshore
 Funds from Profits Tax)

By fax to (852) 2861 1494

By e-mail to consult@fstb.gov.hk

By online <http://www.info.gov.hk/fstb>
submission to

4. Please note that the names of respondents and their comments may be posted on the website of FSTB or referred to in other public documents. If a respondent does not wish his/her name to be disclosed, he/she should state that he/she wishes his/her name to be withheld from publication when sending in his/her comments.

CONSULTATION PAPER ON EXEMPTION OF OFFSHORE FUNDS FROM PROFITS TAX

Introduction

The Secretary for Financial Services and the Treasury invites your comments on the proposed legislative amendments to the Inland Revenue Ordinance (IRO) (Cap. 112) for exempting offshore funds from Profits Tax.

2. The aim of this consultation paper is to solicit your views on the proposed legislation.

Background

3. To reinforce the status of Hong Kong as an international financial centre, the Government announced in the 2003-04 Budget to exempt offshore funds from profits tax. It is necessary to amend the IRO to bring the proposal into effect. At the same time, it is also essential to put in place appropriate anti-avoidance provisions to prevent abuse. This exercise will bring Hong Kong in line with major international financial centres such as New York and London where offshore funds meeting specific requirements are not subject to tax.

4. Under section 14 of the 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. Where the person is a non-resident and the business is carried on through an agent, section 20A of the IRO requires that the non-resident can be charged to tax in the name of the agent and that the tax can be recovered from the agent. This is unless the agent is relieved from such a requirement under section 20AA of the IRO.

5. Under Section 20AA of the IRO and subject to certain conditions, brokers and approved investment advisers are relieved from the requirement to pay in the capacity of agents the possible Profits Tax liability of their non-resident clients in relation to transactions they handled on behalf of these clients. It should be noted that this section does not exempt any possible Profits Tax liability on the part of the non-resident clients themselves.

6. In other words, it is theoretically possible for either a Hong Kong investment adviser or broker, as agent falling outside section 20AA, to be liable for Profits Tax in respect of transactions carried out on behalf of the non-resident client, or the non-resident person to be directly chargeable to Profits Tax in respect of his profits arising in or derived from Hong Kong. However, due to difficulty in obtaining details of transactions involving non-resident persons, in practice the Inland Revenue Department is not in a position to enforce the relevant provisions effectively.

Existing specific exemptions under section 26A(1A)

7. Section 26A(1A) of the IRO was first introduced in 1983. After several amendments, it presently exempts from Profits Tax the profits derived in the ordinary course of fund management activities of specified investment funds. Funds qualified for this exemption include:

- (a) a mutual fund, unit trust or similar investment scheme authorized as a collective investment scheme under section 104 of the Securities and Futures Ordinance (Cap. 571); or
- (b) a mutual fund, unit trust or similar investment scheme where the Commissioner of Inland Revenue is satisfied that it is a bona fide widely held investment scheme which complies with the requirements of a supervisory authority within an acceptable regulatory regime.

8. The effect of these provisions is that 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” would not be exempt under section 26A(1A). It is recognized that quite a number of offshore funds fall within this category and therefore cannot enjoy the exemption. These funds are managed in Hong Kong and represent an important part of the Hong Kong fund industry.

The Proposed Amendments

9. To implement the proposal of granting tax exemption to offshore funds, a new section would need to be added to the IRO. The section would also need to contain specific anti-avoidance provisions to overcome the possibility of round-tripping. This refers to local funds disguised as offshore funds to take advantage of the proposed exemption. It is considered that existing general anti-avoidance provisions (sections 61 and 61A) in the IRO may not be adequate or efficient enough to combat sophisticated tax schemes in this area.

10. Section 20AA was added in 1996 to exempt brokers and approved investment advisers from being treated as agents of non-resident persons, provided a number of conditions are met. The proposed provisions for exempting offshore funds from Profits Tax could therefore be conveniently added as section 20AB, given that the objective of the current exercise is to exempt a non-resident person from Profits Tax in respect of any income derived from transactions undertaken in Hong Kong through an agent who is a broker or an approved investment adviser falling within section 20AA of the IRO.

Section 20AB – the proposed section

11. The exemption in the proposed section 20AB(1) covers not only fund entities resident outside Hong Kong, but also non-fund entities such as individuals, trusts and corporations resident outside Hong Kong. There is a requirement that the transactions are carried out by a broker or

an approved investment adviser who meets the conditions under section 20AA of the IRO.

12. Section 20AB(2) contains specific anti-avoidance provisions to prevent abuse. For this purpose, the exemption would not apply in the following circumstances -

- (a) The non-resident person is carrying on other trade, profession or business in Hong Kong, in addition to transactions through brokers or approved investment advisers falling within section 20AA (“the requirement of not carrying on any other business in Hong Kong”). It has all along been the stance of the Government that a non-resident person is one who has no permanent business presence in Hong Kong [section 20AB(2)(a)].
- (b) The interest of non-resident persons in the relevant entity is below a threshold, viz -
 - (i) where the non-resident person is a corporation, non-residents fulfilling the requirement of not carrying on any other business in Hong Kong beneficially own less than 80% of its issued share capital at any time during the year of assessment [section 20AB(2)(b)(i)];
 - (ii) where the non-resident person is the trustee of a trust estate, beneficiaries under the trust who are non-resident persons and fulfilling the requirement of not carrying on any other business in Hong Kong beneficially own less than 80% of the value of the estate at any time during the year of assessment [section 20AB(2)(b)(ii)]; and
 - (iii) where the non-resident is a partnership, non-resident persons fulfilling the requirement of not carrying on any other business in Hong Kong are beneficially entitled to less than 80% of its profits at any time during the year of assessment [section 20AB(2)(b)(iii)].

13. Section 20AB(5) provides a definition for a beneficiary of a trust estate. Schedule 13 sets out the provisions for determining owners of issued share capital of corporations and ascertaining amount of share capital owned by such owners. Schedule 14 sets out the provisions for determining persons entitled to profits of partnerships and ascertaining amount of profits such persons are entitled to.

14. The draft provisions we intend to include in the Bill are at
---- **Annex A.**

Enforcement of the anti-avoidance provisions

15. In order to combat abuse, the Government considers it important that sufficient records should be kept by the brokers/investment advisers for the Inland Revenue Department to verify the non-resident status of the investors claiming exemption under section 20AB(1) and that the exemption threshold referred to in section 20AB(2)(b) has not been exceeded. However, the Administration is also mindful of the compliance burden this requirement might pose on the fund management industry. The Administration considers that the following are some possible options -

---- (a) to set out clearly in the legislation the types of records (examples at **Annex B**) that need to be kept by the brokers/investment advisers for provision to the Inland Revenue Department either regularly or as and when required; or

(b) to provide in the legislation that the burden of proof of tax exemption eligibility rests with the brokers/investment advisers. This can be satisfied, for example, by the brokers/investment advisers submitting to the Commissioner of Inland Revenue, either regularly or as and when required, written confirmation by all non-resident clients that the criteria for tax exemption have been satisfied.

Comments sought

16. The Government seeks your comments on the following -
- (a) As far as tax incentives are concerned, do you agree that the proposed legislation is sufficient for attracting offshore funds to Hong Kong and enabling Hong Kong to compete with other countries with similar exemptions on a level playing field? If not, why not and what other aspects do we need to consider?
 - (b) Do you think the proposed anti-avoidance provisions in section 20AB(2) are effective in preventing round-tripping of local funds from taking advantage of the tax exemption? If not, why not and what other elements should be included?
 - (c) Do you consider the 80% threshold in section 20AB(2)(b) reasonable? If not, why not and what is the threshold you consider appropriate?
 - (d) Would you have difficulty in complying with the record-keeping requirement options set out in paragraph 15? If yes, please provide details about the difficulties and your other suggestions which can achieve the same purpose.

Financial Services and the Treasury Bureau
14 January 2004

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Draft Provisions of the Inland Revenue (Amendment) Bill 2004

1. Short Title

This Ordinance may be cited as the Inland Revenue (Amendment) Ordinance 2004.

2. Section added

The Inland Revenue Ordinance (Cap. 112) is amended by adding –

**“20AB. Certain profits of non-residents
excluded from assessable profits**

(1) Notwithstanding section 20A but subject to subsection (2), a non-resident person's profits arising in or derived from Hong Kong from any transaction described in section 20AA(1)(a) or (b) for any year of assessment commencing on or after [1 April 1997] shall not be included in computing the person's assessable profits.

(2) Subsection (1) does not apply to the computation of a non-resident person's assessable profits for a year of assessment if –

(a) the person carries on any trade, profession or business in Hong Kong involving any transaction other than a transaction referred to in subsection (1) in that year of assessment; or

(b) at any time during that year of assessment –

(i) in the case where the person is a corporation, non-resident persons who have not carried on any trade, profession or business in Hong Kong involving any transaction other than a transaction referred to in subsection (1) in that year of assessment beneficially own less than 80% of its issued share capital;

- (ii) in the case where the person is the trustee of a trust estate, beneficiaries under the trust who are non-resident persons and who have not carried on any trade, profession or business in Hong Kong involving any transaction other than a transaction referred to in subsection (1) in that year of assessment beneficially own less than 80% of the value of the estate;
- (iii) in the case where the person is a partnership, non-resident persons who have not carried on any trade, profession or business in Hong Kong involving any transaction other than a transaction referred to in subsection (1) in that year of assessment are beneficially entitled to less than 80% of its profits.

(3) For the purposes of subsection (2)(b)(i), where the issued share capital of the corporation concerned is owned through one or more corporations, Schedule 13 applies in determining the owners of the share capital and in ascertaining the amount of the share capital owned by such owners.

(4) For the purposes of subsection (2)(b)(iii), where entitlements to the profits of a partnership are derived through one or more corporations, Schedule 14 applies in determining the persons who are entitled to the profits and in ascertaining the amount of the profits to which such persons are entitled.

(5) In this section, “beneficiary” (), in relation to a trust estate, means any person who benefits or is capable (whether by the exercise of a power of appointment or otherwise) of benefiting under the trust estate, either directly or through any interposed person, or who is able or might reasonably be expected to be able, whether directly or indirectly,

to control the activities of the trust estate or the application of its corpus or income.

3. Schedule added

The following is added –

“SCHEDULE 13

[s.20AB(3)]

**PROVISIONS FOR DETERMINING OWNERS OF
ISSUED SHARE CAPITAL OF CORPORATIONS
AND ASCERTAINING AMOUNT OF SHARE
CAPITAL OWNED BY SUCH OWNERS**

1. Where the share capital of the subject corporation, being the corporation the beneficial ownership of the share capital of which is to be determined for the purposes of section 20AB(2)(b)(i) of this Ordinance, is directly owned by another corporation (“first corporation”) and the share capital of the first corporation is directly owned by a person who is an individual, that person shall be deemed to own the share capital of the subject corporation through the first corporation; and if that person is a corporation (“second corporation”) and its share capital is directly owned by another person who is an individual, that other person shall be deemed to own the share capital of the subject corporation through the first corporation and second corporation, and so on.

2. In this Schedule –

- (a) where an individual is deemed to own the share capital of the subject corporation through one or more other corporations, the individual, the subject corporation and the corporation or corporations through which the share capital is deemed to be so owned are referred to as “a series”;

- (b) in a series –
 - (i) the individual who is deemed to own the share capital of the subject corporation through one or more other corporations is referred to as “the deemed owner”;
 - (ii) the corporation through which the deemed owner owns the share capital of the subject corporation is referred to as “an intermediary” and if there is more than one such corporation, these corporations are referred to as “a chain of intermediaries”;
- (c) a person in a series who directly owns share capital of a corporation in the series is referred to as “an owner”;
- (d) any two persons in a series of which one owns share capital of the other directly, and not through an intermediary or a chain of intermediaries, are referred to as being directly related to one another.

3. Where an individual in a series holds the share capital of a corporation in the series to which he is directly related on trust for another corporation (“corporate beneficiary”), the provisions of this Schedule shall apply as if the trust had not existed and the share capital were directly owned by the corporate beneficiary.

4. Where every owner in a series owns the whole of the share capital of the corporation to which the owner is directly related, the deemed owner shall be deemed to own through the intermediary or chain of intermediaries the whole of the share capital of the subject corporation.

5. Where one of the owners in a series owns a fraction of the share capital of the corporation to which the owner is directly related, and every other owner in the series owns the whole of the share capital of the corporation to which the owner is directly related, the deemed owner shall be deemed to own that fraction of the share capital of the subject corporation through the intermediary or chain of intermediaries.

6. Where more than one of the owners in a series owns a fraction of the share capital of the corporation to which the owner is directly related, and every other owner in the series owns the whole of the share capital of the corporation to which the owner is directly related, the deemed owner shall be deemed to own through the intermediary or chain of intermediaries such fraction of the share capital of the subject corporation as results from the multiplication of those fractions.

7. Where every owner in a series owns a fraction of the share capital of the corporation to which the owner is directly related, the deemed owner shall be deemed to own through the intermediary or chain of intermediaries such fraction of the share capital of the subject corporation as results from the multiplication of those fractions.

SCHEDULE 14

[s.20AB(4)]

PROVISIONS FOR DETERMINING PERSONS ENTITLED TO PROFITS OF PARTNERSHIPS AND ASCERTAINING AMOUNT OF PROFITS SUCH PERSONS ARE ENTITLED TO

1. Where a partner of the subject partnership, being the partnership the entitlement to the profits of which is to be determined for the purposes of section

20AB(2)(b)(iii) of this Ordinance, is a corporation (“first corporation”) and the share capital of the first corporation is directly owned by a person who is an individual, that person shall be deemed to be entitled to the profits of the subject partnership through the first corporation; and if that person is a corporation (“second corporation”) and its share capital is directly owned by another person who is an individual, that other person shall be deemed to be entitled to the profits of the subject partnership through the first corporation and the second corporation, and so on.

2. In this Schedule –

- (a) where an individual is deemed to be entitled to the profits of the subject partnership through one or more corporations, the individual, the subject partnership and the corporation or corporations through which the individual is deemed to be entitled to such profits are referred to as “a series”;
- (b) in a series –
 - (i) the individual who is deemed to be entitled to the profits of the subject partnership through one or more corporations is referred to as “the deemed partner”;
 - (ii) the corporation through which the deemed partner is entitled to the profits of the subject partnership is referred to as “an intermediary” and if there is more than one such corporation, these corporations are referred to as “a chain of intermediaries”;
- (c) a person in a series who directly owns share capital of a corporation in the series is referred to as “an owner”;

- (d) any two persons in a series of which one owns share capital of the other directly, and not through an intermediary or a chain of intermediaries, are referred to as being directly related to one another;
- (e) the fraction of the profits of the subject partnership in a series to which the corporation in the series that is a partner of the subject partnership is entitled is referred to as “the relevant fraction”.

3. Where an individual in a series holds the share capital of a corporation in the series to which he is directly related on trust for another corporation (“corporate beneficiary”), the provisions of this Schedule shall apply as if the trust had not existed and the share capital were directly owned by the corporate beneficiary.

4. Where every owner in a series owns the whole of the share capital of the corporation to which the owner is directly related, the deemed partner shall be deemed to be entitled to the relevant fraction of the profits of the subject partnership through the intermediary or chain of intermediaries.

5. Where one or more of the owners in a series owns a fraction of the share capital of the corporation to which the owner is directly related, and every other owner in the series owns the whole of the share capital of the corporation to which the owner is directly related, the deemed partner shall be deemed to be entitled to such fraction of the profits of the subject partnership through the intermediary or chain of intermediaries as results from the multiplication of that fraction or those fractions (as the case may be) and the relevant fraction.

6. Where every owner in a series owns a fraction of the share capital of the corporation to which the owner is directly related, the deemed partner shall be

deemed to be entitled to such fraction of the profits of the subject partnership through the intermediary or chain of intermediaries as results from the multiplication of those fractions and the relevant fraction.”.

Explanatory Memorandum

This Bill amends the Inland Revenue Ordinance (Cap.112) to provide that a non-resident person’s profits arising in Hong Kong from a transaction that is carried out through a broker and complying with the conditions set out in section 20AA(2) or through an approved investment adviser and complying with the conditions set out in section 20AA(3) are exempt from profits tax.

2. A non-resident person will however lose this exemption in a year of assessment if –

- (a) he carries on any trade, profession or business in Hong Kong involving any transaction other than a transaction described above in that year of assessment; or
- (b) in cases where the person is a corporation, a trustee of a trust estate or a partnership, at any time during that year of assessment, the stake in the corporation, trust estate or partnership of non-residents who have not carried on any transaction, profession or business in Hong Kong involving any transaction other than a transaction described above in that year drops below 80%.

Exemption of Offshore Funds from Profits Tax

Proposed List of Information on each Non-resident Person exempt under Section 20AB(1) to be kept by Brokers/Approved Investment Advisers referred to in Section 20AA

| | Corporation | Trust Fund | Partnership |
|---|---|--|--|
| 1 | Name and Address | | |
| 2 | Place of Incorporation (in case of corporations) and Country of Residence | | |
| 3 | Nature of Business | | |
| 4 | Whether any Business (other than Section 20AA Transactions) carried on in Hong Kong, and the Tax File Reference, if applicable | | |
| 5 | Paid-up Capital | Value of Estate | Capital |
| 6 | Respective Percentage of Shareholding ultimately owned by “Hong Kong Residents” and “non-Hong Kong Residents”, within the meaning of section 20AB(2)(b)(i), throughout the Basis Period | Respective Percentage of the value of the trust estate beneficially owned by “Hong Kong Residents” and “non-Hong Kong Residents”, within the meaning of section 20AB(2)(b)(ii), throughout the Basis Period. | Respective Percentage of Profits “Hong Kong Residents” and “Non-Hong Kong Residents”, within the meaning of section 20AB(2)(b)(iii), are ultimately entitled to throughout the Basis Period. |