

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

## **Introduction**

We invite your comments on a revised approach to exempting offshore funds from Profits Tax.

2. 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. A consultation paper was issued in January 2004 proposing certain legislative amendments to the Inland Revenue Ordinance (IRO) (Cap. 112) to give effect to the exemption. We have received responses from the industry and other interested parties. Having carefully considered the depositions and explored various options, the Administration has developed a revised approach to amend the Inland Revenue Ordinance to effect the exemption. The aim of this consultation paper is to solicit your views on the revised approach.

## **Background**

3. 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. Under section 20AA of the IRO, brokers and approved investment advisers, subject to certain

conditions, are relieved from the requirement to pay in the capacity of agents the possible Profits Tax liability of their non-resident clients.

4. Section 26A(1A) of the IRO presently exempts specified investment funds from Profits Tax. Funds qualified for this exemption include a mutual fund, unit trust or similar investment scheme authorized under the Securities and Futures Ordinance (Cap. 571) or 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 regime. It is recognized that quite a number of offshore funds do not fall within the ambit of section 26A(1A) and therefore cannot enjoy the exemption.

5. The objective of the proposed exemption is to exempt a non-resident person from Profits Tax in respect of any income derived from securities trading transactions<sup>1</sup> undertaken in Hong Kong through an agent who is a broker or an approved investment adviser falling within section 20AA of the IRO. The exemption would cover both fund entities and non-fund entities (such as individuals, trusts and corporations) resident outside Hong Kong. The exemption, however, would not apply if the non-resident person is carrying on any trade, profession or business in Hong Kong in addition to the transactions falling within section 20AA of the IRO.

6. To implement the exemption, the Administration sees the need of enacting specific anti-avoidance provisions to overcome the possibility of round-tripping (i.e. local funds and other entities disguised as offshore funds and other entities to take advantage of the exemption).

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<sup>1</sup> The term “securities” is defined in Schedule 1 of the Securities and Futures Ordinance (Cap. 571). An extract is at Annex for reference.

## **Former Approach**

7. The consultation paper of January 2004 proposed to effect the exemption and the anti-avoidance measure by granting the exemption only to a non-resident person (including a corporation, a trustee of a trust estate or a partnership) which is mainly owned by non-resident beneficial interests. In the consultation paper, the exemption threshold of non-resident interest was set at 80% or above, i.e. the exemption would not apply if the aggregate beneficial interests in the non-resident person held by non-residents are less than 80%.

8. Under this approach, brokers/investment advisers would be required to keep sufficient records to verify the non-resident status of each of the investors claiming the exemption and that the 80% exemption threshold had not been breached.

9. In response to the consultation paper, the industry and other interested parties raised much concern about the heavy compliance burden placed on brokers/investment advisers for keeping records and the difficulty faced by them in ascertaining the residence status of the ultimate beneficial owners.

## **The Revised Approach**

10. Having considered various submissions and possible options, the Administration has developed a revised approach to effecting the exemption. Under the revised approach, two sets of provisions would be enacted in the IRO – the Exemption Provisions and the Deeming Provisions.

### *The Exemption Provisions*

11. The Exemption Provisions would grant Profits Tax exemption to a non-resident [including an individual, a partnership, a trustee and a corporation] without regard to the composition of its beneficial owners. Brokers/investment advisers would no longer be required to keep records on the residence status of the ultimate beneficial interests in the non-resident person claiming the exemption. Similar to the Former Approach, profits qualified for exemption are profits derived from Hong Kong from securities trading transactions carried out through section 20AA brokers/investment advisers and, to be entitled to the exemption, the non-resident person must not carry on any other business in Hong Kong.

### *The Deeming Provisions*

12. To reflect the requirement that a resident should not take the benefit of the exemption [which is intended for non-residents], the Deeming Provisions would deem assessable profits on a resident holding beneficial interest in a tax-exempt non-resident in respect of profits earned by the non-resident from securities trading transactions carried out through brokers/investment advisers in Hong Kong (see more details in para 15 below). 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 Inland Revenue Department (IRD).

13. The Administration considers that it would be unlikely for a

resident to carry out round-tripping transactions through holding interests in a non-resident fund exempted from tax under section 26A(1A) of the IRO or a fund that is, though not authorized, bona fide widely held. The Deeming Provisions, therefore, would not be invoked on a resident in such cases.

14. The Administration appreciates that a resident investor holding a small interest may have difficulty in obtaining information from a non-resident on the latter's securities trading transactions in Hong Kong for reporting deemed assessable profits to the IRD. The application of the Deeming Provisions would be confined to the following situations-

- (a) a resident investor, alone or with his associates whether resident or non-resident, directly or indirectly holds a certain percentage of the beneficial interest or above that percentage in a tax-exempt non-resident (this threshold should be say 30%); or
- (b) a resident investor directly or indirectly holds any percentage of the beneficial interest in a tax-exempt non-resident which is his associate.

15. It must be emphasized that the Deeming Provisions only operate to recoup tax payable by a resident in respect of taxable profits derived from securities trading transactions carried out in Hong Kong in the name of the tax-exempt non-resident. The Deeming Provisions would in no way extend the charge of Profits Tax to non-taxable capital gains or offshore profits. Specifically, the Deeming Provisions would not be invoked in the following situations-

- (a) If a non-resident person does not trade but only invest in Hong Kong securities, any gains on sale of securities are capital gains not

chargeable to Profits Tax under section 14 of the IRO. The non-resident person does not need to rely on the Exemption Provisions. The Deeming Provisions would not be invoked on any of its resident beneficial owners.

- (b) If a non-resident person deals in overseas securities, any trading profits from such dealings are offshore profits not chargeable to Profits Tax under section 14 of the IRO. The Deeming Provisions would not be invoked on any of its resident beneficial owners.
- (c) The Deeming Provisions would not be invoked on a resident if he sets up a foreign company to invest (not trade) in Hong Kong securities or to deal in overseas (not Hong Kong) securities. The resultant capital gains or offshore profits all along are not chargeable to Profits Tax under the IRO.

### **Comments Sought**

16. The Government seeks your comments on the revised approach outlined in paragraphs 10 to 15 above. Please send your views on the above issues to the following address by letter or by fax (Fax number: 2530 5921), on or before 31 January 2005:

Principal Assistant Secretary for the Treasury (Revenue)  
Treasury Branch, Financial Services and the Treasury Bureau  
4th Floor, Central Government Offices, Main Wing  
Lower Albert Road  
Hong Kong

Financial Services and the Treasury Bureau  
December 2004

Definition of “securities” in Schedule 1 of the Securities and Futures Ordinance (Cap. 571)

“securities” (證券) means-

- (a) shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a body, whether incorporated or unincorporated, or a government or municipal government authority;
- (b) rights, options or interests (whether described as units or otherwise) in, or in respect of, such shares, stocks, debentures, loan stocks, funds, bonds or notes;
- (c) certificates of interest or participation in, temporary or interim certificates for, receipts for, or warrants to subscribe for or purchase, such shares, stocks, debentures, loan stocks, funds, bonds or notes;
- (d) interests in any collective investment scheme;
- (e) interests, rights or property, whether in the form of an instrument or otherwise, commonly known as securities;
- (f) interests, rights or property which is interests, rights or property, or is of a class or description of interests, rights or property, prescribed by notice under section 392 of this Ordinance as being regarded as securities in accordance with the terms of the notice,

but does not include-

- (i) shares or debentures of a company that is a private company within the meaning of section 29 of the Companies Ordinance (Cap 32);
- (ii) any interest in any collective investment scheme that is-
  - (A) a registered scheme as defined in section 2(1) of the Mandatory Provident Fund Schemes Ordinance (Cap 485), or its constituent fund as defined in section 2 of the Mandatory Provident Fund Schemes (General) Regulation (Cap 485 sub. leg. A);
  - (B) an occupational retirement scheme as defined in section 2(1) of the Occupational Retirement Schemes Ordinance (Cap 426); or

- (C) a contract of insurance in relation to any class of insurance business specified in the First Schedule to the Insurance Companies Ordinance (Cap 41);
- (iii) any interest arising under a general partnership agreement or proposed general partnership agreement unless the agreement or proposed agreement relates to an undertaking, scheme, enterprise or investment contract promoted by or on behalf of a person whose ordinary business is or includes the promotion of similar undertakings, schemes, enterprises or investment contracts (whether or not that person is, or is to become, a party to the agreement or proposed agreement);
- (iv) any negotiable receipt or other negotiable certificate or document evidencing the deposit of a sum of money, or any rights or interest arising under the receipt, certificate or document;
- (v) any bill of exchange within the meaning of section 3 of the Bills of Exchange Ordinance (Cap 19) and any promissory note within the meaning of section 89 of that Ordinance;
- (vi) any debenture that specifically provides that it is not negotiable or transferable;
- (vii) interests, rights or property which is interests, rights or property, or is of a class or description of interests, rights or property, prescribed by notice under section 392 of this Ordinance as not being regarded as securities in accordance with the terms of the notice;