

## PROFITS TAX EXEMPTION FOR OFFSHORE FUNDS

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The Hong Kong government just enacted a new legislation called the Revenue (Profits Tax Exemption for Offshore Funds) Ordinance 2006 (“the Exemption Ordinance”) on 1<sup>st</sup> March 2006. According to this new law, offshore funds, upon satisfying certain conditions, can be exempted from corporate tax on profits derived from certain securities transactions in Hong Kong. The purpose of enacting the Exemption Ordinance is to reinforce Hong Kong’s position as an international financial centre and to bring it in line with other major international financial centres. The exemption provided in the Exemption Ordinance has retrospective effect and applies to the year of tax assessment from 1996/97 onwards.

### I. Qualifications for Tax Exemption

Under the Exemption Ordinance, the profits derived from a fund in Hong Kong (no matter it is a natural person, partnership, trustee or corporation) can be exempted from Profits Tax if it satisfies the following three criteria:

- the fund is regarded as a “**Non-resident**” in Hong Kong; and
- the fund does not carrying out other business activities in Hong Kong except for conducting “**qualifying transactions**”; and
- the qualifying transactions are conducted by the fund through “**specified persons**”.

#### A. Definition of a “Non-Resident” Fund

To be qualified for tax exemption, the fund must be regarded as a “non-resident” under the Exemption Ordinance. Different definition is applied to both natural person and entities.

A natural person will be regarded as non-resident in Hong Kong if:-

- a. he or she is not ordinarily resides in Hong Kong during the year of assessment in question; or
- b. he or she stays in Hong Kong for a period or a number of periods amounting to not more than 180 days during the year of assessment in question or for a period or a number of periods amounting to not more than 300 days in 2 consecutive years of assessment one of which is the year of assessment in question.

In a partnership, corporation or trustee case, the fund will be regarded as a non-resident in Hong Kong if its “central management and control” is located outside Hong Kong. Under the well-established common law rule, the central management and control of a company is determined by reference to the location where the daily decision making activities are located. In practice, it will be the location where the board of directors’ meetings are held.

#### B. Definition of “Qualifying Transactions”

In additions to the above residency test, the Exemption Ordinance also requires that the



fund cannot carrying out other business activities in Hong Kong except for conducting those “qualifying transactions”, which includes a transaction in:-

- securities
- futures contracts
- foreign exchange contracts
- making of a deposit other than by way of money-lending business
- foreign currencies
- exchange-traded commodities

The Exemption Ordinance also exempts profits from transactions that are incidental to carrying out the above qualifying transactions insofar as income of such incidental transactions does not exceed 5% of the total trading receipts derived from carrying out the qualifying and incidental transactions.

It is important to note that, if an offshore fund carries on any business in Hong Kong (other than those tax-exempted qualifying and incidental transactions as mentioned above), it will be disqualified for tax-exemption for the whole year of assessment. However, the Exemption Ordinance does not define the terms of “incidental transactions” and “other business”. We expect that the Inland Revenue Department (“IRD”) will provide a more detailed guidance on this subject in its Departmental Interpretation and Practice Note to be issued in near future.

#### C. Definition of “Specified Persons”

In additions to the above requirements, the Exemption Ordinance also requires that the qualifying transactions must be conducted through “specified persons”. The words “specified persons” are defined as those corporations and authorized financial institutions that are licensed or registered under Part V of the Securities and Futures Ordinance.

## II. Anti-Avoidance Measures

To prevent Hong Kong residents from taking advantage of the Exemption Ordinance by transferring funds to non-resident companies for carrying out securities-trading activities in Hong Kong, the Exemption Ordinance also includes deeming provisions for protecting the revenue. The deeming provision will apply to a resident who, alone or jointly with his associates, holds beneficial interest of 30% or more in an exempt offshore fund, or holds any percentage where the exempted offshore fund is an associate of the resident.

Please note that there is a broad definition of “associates” under the Inland Revenue Ordinance (“IRO”). Pursuant to section 21A(3) of the IRO, a person or entity will be regarded as an “associate” of a taxpayer:-

- a. If the taxpayer is a natural person:
  - a relative of the taxpayer
  - a partner of the taxpayer, or a relative of that partner;



a partnership in which the taxpayer is a partner;  
a corporation controlled by the taxpayer, or by any of the persons listed above;  
a director or principal officer of such as corporation.

b. If the taxpayer is a corporation:

an associated corporation (i.e. either a corporation over which the taxpayer has control;  
or a corporation which has control over the taxpayer; or a corporation under the same  
control as the taxpayer);  
a person who controls the corporation, or a partner of such person, or a relative of the  
controller or partner;  
a director or principal officer of the corporation (or any associated corporation), or a  
relative of that director or officer;  
a partner of the corporation, or a relative of a partner.

c. If the taxpayer is a partnership:

any partner, and if a partner is a partnership, any partner of that partnership;  
any partner with the partnership in any other partnership, and if that partner is a  
partnership, any partner of that partnership;  
any relative of any partner;  
a corporation controlled by the partnership, or by a partner or any relative of a partner;  
a director or principal officer of such a corporation;  
a corporation of which any partner is a director or principal officer.

When the above deeming provision is triggered, the resident will be deemed to have derived taxable profits from such offshore funds in Hong Kong. However, the deeming provision will not be applicable if the fund in questions is authorized by the Securities and Futures Commission or is a bona fide widely-held fund.

To allow adequate time for the industry to change its systems to facilitate the provision of information to resident investors for tax return purposes, the above deeming provisions will apply from the year of assessment 2006/07.

### III. Our Comments

We opine that the enactment of the Exemption Ordinance will benefit the local financial industry and the related downstream industries such as lawyer, accounting and business consultancy services. It can in long run enhance Hong Kong's position a major financial center in the region. However, as mentioned above, there are still many practical issues with which the IRD has to clarify. Investors therefore should pay attention to the Departmental Interpretation and Practice Notes concerning this Exemption Ordinance, which will be issued very soon.

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