



Inland Revenue Department
The Government of the Hong Kong Special Administrative Region
of the People's Republic of China

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 43 (REVISED)

PROFITS TAX

PROFITS TAX EXEMPTION FOR OFFSHORE FUNDS

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the laws as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

These notes replace those issued in February 2010.

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Commissioner of Inland Revenue

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CONTENT

	Paragraph
Introduction	1
Background	
Before the 2006 Ordinance	4
The 2006 Ordinance	6
The 2015 Ordinance	7
Resident person / Non-resident person	8
Individuals	9
Non-individual entities	12
Central management and control	13
Split year residence	21
The Exemption Provisions	
Exemption criteria	22
Scope of Exemption	23
Specified Transactions	24
Transaction in securities	26
Transaction in futures contracts	29
Transaction in foreign exchange contracts	32
Transaction consisting in the making of a deposit other than by way of a money-lending business	33
Transaction in foreign currencies	34
Transaction in exchange-traded commodities	35
Incidental transactions	36
Specified person	39
Loss from exempt transactions	41
Effective date	42
The Deeming Provisions	
General	43

Direct beneficial interest	45
Indirect beneficial interest	48
Control of a trust estate	51
Associate	52
Examples on applying the Deeming Provisions by reference to beneficial interests	55
Ascertainment of deemed profits	56
No deemed loss for resident persons	59
Deeming Provisions not to apply in certain circumstances	61
Reporting requirements	65
Effective date	68
Tax Avoidance	
General anti-avoidance provisions	69
 Appendices A - D	

INTRODUCTION

Hong Kong is a major international financial centre (IFC) in the Asia Pacific region. The financial services industry plays an important role in the Hong Kong economy and contributes to a significant percentage of Hong Kong's GDP. It is therefore vital to maintain and strengthen Hong Kong's competitiveness as an IFC. In Hong Kong, a substantial portion of the total assets managed by the fund management industry is sourced from overseas investors. Like other major IFCs (including New York, London and Singapore), Hong Kong offers tax concession to offshore funds. Offshore funds, for the purposes of this Note, refer to non-resident entities, whether individuals, corporations, partnerships or trustees of trust estates. Anchoring offshore funds in the Hong Kong market has helped maintaining international expertise, promoting new products and further developing the local fund management business. It has also benefited other downstream services sectors such as brokers, accountants, bankers and lawyers.

2. The Revenue (Profits Tax Exemption for Offshore Funds) Ordinance 2006 (the 2006 Ordinance) was enacted in March 2006. The 2006 Ordinance added below sections and schedules to the Inland Revenue Ordinance (the Ordinance):

- (a) Section 20AB contains provisions for use in the interpretation of sections 20AC to 20AE and Schedule 15, which include provisions in determining the residency status of an individual, a corporation, a partnership and a trustee of a trust estate and the extent of a person's direct or indirect beneficial interest in another person.
- (b) Section 20AC stipulates that the exemption applies retrospectively from the year of assessment 1996/97 onwards and the circumstances in which the exemption can be allowed (the Exemption Provisions).
- (c) Section 20AD provides that losses arising from the exempt transactions carried out by an offshore fund cannot be used to set off against its future assessable profits.

- (d) Section 20AE stipulates the circumstances in which the assessable profits of a tax-exempt offshore fund are to be regarded as the assessable profits of a resident person (the Deeming Provisions).
- (e) Section 70AB contains provisions for the revision of an assessment necessitated by the retrospective application of the Exemption Provisions.
- (f) Schedule 15 contains the formula for ascertaining the amount to be regarded as the assessable profits of a resident person under the Deeming Provisions.
- (g) Schedule 16 lists the specified transactions that are covered by the exemption.

3. In July 2015, the Inland Revenue (Amendment) (No. 2) Ordinance 2015 (the 2015 Ordinance) was enacted to extend the profits tax exemption for offshore funds to offshore private equity funds. The 2015 Ordinance also amended some of the provisions of the offshore fund regime. Thus, there is a need to revise this Note to bring it up-to-date. Regarding the interpretation and practices related to profits tax exemption for offshore private equity funds, reference should be made to Departmental Interpretation and Practice Notes No. 51 (Profits Tax Exemption for Offshore Private Equity Funds).

BACKGROUND

Before the 2006 Ordinance

4. Profits tax is imposed on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong from such trade, profession or business, but excluding profits arising from the sale of capital assets. Before the enactment of the 2006 Ordinance, a person, resident or non-resident, was chargeable to profits tax in respect of his trading profits derived from securities transactions carried out in Hong Kong if those transactions amounted to the carrying on of a trade or business. However, profits tax was not and remains not chargeable in respect of offshore profits or capital gains, including those derived from securities transactions.

5. Certain specified investment funds are exempt from profits tax under section 26A(1A) of the Ordinance. These include mutual funds, unit trusts and similar investment schemes which are authorized under the Securities and Futures Ordinance (SFO) (Cap. 571), and those investment schemes where the Commissioner of Inland Revenue (the Commissioner) is satisfied that they are bona fide widely held and comply with the requirements of a supervisory authority within an acceptable regime. Mutual funds, unit trusts and other similar investment schemes, including offshore funds, which are neither authorized nor “bona fide widely held and supervised” do not qualify for the tax exemption under section 26A(1A).

The 2006 Ordinance

6. Broadly speaking, two sets of provisions were introduced – the Exemption Provisions and the Deeming Provisions. The Exemption Provisions exempt non-resident persons (including individuals, corporations, partnerships and trustees¹ of trust estates) from tax in respect of profits derived from certain specified transactions carried out through or arranged by specified persons. To qualify for the exemption, a non-resident person must not carry on any other business in Hong Kong other than the specified transactions, or transactions incidental to the carrying out of the specified transactions. The exemption did not however cover profits derived from transactions in the shares, debentures or the related rights, options, etc. of a private company. The Exemption Provisions apply with retrospective effect from the year of assessment 1996/97. The exemption is intended for non-resident persons only. The Deeming Provisions are enacted to prevent abuse, or round-tripping, by resident persons disguised as non-resident persons to take advantage of the exemption. In appropriate circumstances, a resident person will be deemed to have derived assessable profits in respect of the trading profits earned by an offshore fund from the specified transactions and incidental transactions in Hong Kong. The Deeming Provisions apply from the year of assessment 2006/07.

¹ Tax liability is imposed on the trustee of a trust estate as the chargeable person - *section 2 of the Ordinance includes “trustee” as a person.* Therefore, the Exemption Provisions seek to exempt the trustees of trust estates from tax where appropriate.

The 2015 Ordinance

7. The definition of “securities” in Part 2 of Schedule 16 to the Ordinance has been amended so that profits tax exemption will be extended to cover transactions in securities of an special purpose vehicle (SPV) or excepted private company. Section 20AC has been amended to exempt a non-resident person that is a qualifying fund from profits tax in respect of profits derived from certain specified transactions without engaging a specified person. Section 20ACA is newly added to exempt an SPV from payment of tax in respect of profits derived from certain transactions concerning interposed SPVs or excepted private companies. The 2015 Ordinance applies to transactions in securities of an SPV or excepted private company carried out from 1 April 2015 onwards.

RESIDENT PERSON / NON-RESIDENT PERSON

8. Section 20AB contains the definitions of “resident person” and “non-resident person”. Different legal tests are prescribed for individuals and non-individual entities (which include corporations, partnerships and trustees of trust estates) in determining whether they are resident persons. By definition, a non-resident person is a person who is not a resident person. The definitions of resident person and non-resident person apply equally to both the Exemption Provisions and the Deeming Provisions.

Individuals

9. In relation to a year of assessment, an individual is regarded as a resident person if he: (a) ordinarily resides in Hong Kong in that year of assessment; or (b) stays in Hong Kong for a period or a number of periods amounting to more than 180 days during that year of assessment or more than 300 days in two consecutive years of assessment one of which is that year of assessment. These provisions are the same as those under section 41 of the Ordinance on the meanings of a “permanent resident” and a “temporary resident” who are eligible for election for Personal Assessment.

10. For the purposes of determining an individual’s residency, it is generally considered that an individual “ordinarily resides” in Hong Kong if he

has a permanent home in Hong Kong where he or his family lives. The mere fact that a person holds a Hong Kong identity card is inconclusive in showing that he ordinarily resides in Hong Kong. In this respect, the Board of Review in its decision D57/02, IRBRD vol 17, 829 applied the Court of Appeal case *Director of Immigration v Ng Shun-loi* in deciding whether an individual was ordinarily resident in Hong Kong:

“The Hong Kong Court of Appeal has defined the term ‘ordinarily resident’ in *Director of Immigration v Ng Shun-loi* [1987] HKLR 798, per Hunter J:

“The words “ordinarily resident” mean that the person must be habitually and normally resident here apart from temporary or occasional absences of long or short duration’ (Levene v. IRC [1928] AC 217 applied).

‘A person is resident where he resides. ... When is he ordinarily resident? I think that is when he resides there in the ordinary way. That must be the meaning of the adverb. The expression is therefore contemplating residence for the purposes of everyday life. It is residence in the place where a person lives and conducts his daily life in circumstances which lead to the conclusion that he is living there as an ordinary member of the community would live for all the purposes of his daily life’ (R v. Barnet London Borough Council, ex parte Nilish Shah [1982] 1 QB 688 applied).”

11. In ascertaining the number of days a person stays in Hong Kong, part of a day will be counted as one day. This practice is consistently adopted in applying the 60-day rule under salaries tax in section 8(1B), in deciding the eligibility for election for Personal Assessment and in determining residency for tax treaty purposes.

Non-individual entities

12. Non-individual entities, which include corporations, partnerships and trustees of trust estates, are subject to the same legal test in determining whether they are resident persons. In relation to a year of assessment, a

corporation, a partnership or a trustee of a trust estate is regarded as a resident person if the central management and control of the corporation, partnership or trust estate is exercised in Hong Kong in that year of assessment. In the case of a fund structure with sub-funds or parallel funds, tax exemption may be applicable to each sub-fund or parallel fund if each individual sub-fund or parallel fund can exist as a separate and independent legal entity, having its own distinctive rights and obligations. In practice, the totality of facts (including the constitutive documents, investment mandates, rights and obligations of the investment manager) have to be examined to determine whether a sub-fund or parallel fund can be regarded as a non-resident for the purposes of section 20AC.

Central management and control

13. The “central management and control” test is a well-established common law rule adopted in many jurisdictions, such as Singapore, the UK and Australia, in determining the residence of a company and other non-individual entities. The common law rule was enunciated by Lord Loreburn in *De Beers Consolidated Mines, Limited v Howe* 5 TC 198 at page 213:

“... a company resides, for purposes of Income Tax, where its real business is carried on. ... I regard that as the true rule; and the real business is carried on where the central management and control actually abides.”

14. The central management and control refers to the highest level of control of the business of a company or an entity. The exercise of central management and control does not necessarily require any active involvement. The place where the central management and control is exercised is not necessarily the place where the main operations of the business are to be found, though the two places may often coincide. Further, the place of incorporation of a company or the place of establishment of an entity is not in itself conclusive of the place where the central management and control is exercised, and is therefore not conclusive of the place where the company or entity is resident per the judgment in *Todd v Egyptian Delta Land and Investment Co. Ltd.*, 14 TC 119.

15. The location of central management and control is wholly a question of fact. Each case must be decided on its own facts. Factors that are decisive in one case may carry little weight in another. In general, if the central management and control of a company is exercised by the directors in board meetings or by the partners in partners meetings, the relevant locality is where those meetings are held. In many cases, the directors or partners meets in the country where the business operations take place, and central management and control is clearly located in that country. In other cases, central management and control may be exercised by directors or partners in one jurisdiction though the actual business operations may take place elsewhere. It should be noted that the residence of individual directors or partners is generally not relevant in determining the locality of the central management and control of a company or partnership (see, however, the comments in paragraph 16 below). Therefore, the mere fact that the majority of the directors of a company or partners of a partnership are resident in Hong Kong does not of itself mean that the company or partnership is centrally managed and controlled in Hong Kong, and hence would not adversely affect the application of the tax exemption.

16. The place of board meetings or partners meetings also is not necessarily conclusive. It is significant only in so far as those meetings constitute the medium through which central management and control is exercised. In cases where central management and control of a company or a partnership is in fact exercised by an individual (for example, the board chairman, the managing director or general partner), the relevant locality is the place where the controlling individual exercises his power. As central management and control is a question of fact and reality, when reaching a conclusion in accordance with the case law principles, only factors which exist for genuine commercial reasons will be accepted.

17. The asset portfolios of many overseas funds operating in Hong Kong are managed by fund managers in Hong Kong who are given full discretion to manage the asset portfolios. There may be concerns that the central management and control of those funds might in the circumstances be regarded as being exercised in Hong Kong, and they might be caught as resident persons and hence not qualify for the tax exemption. The Department considers that the residence of the person who manages the asset portfolios on behalf of a fund is not a conclusive factor in determining the residence of the fund. If the

central management and control of a fund is not exercised in Hong Kong, the fund can qualify for the exemption notwithstanding that its asset portfolios are managed by a Hong Kong fund manager under his full discretion.

18. **Appendix A** sets out the Department's views on the residency status of various forms of investment vehicles commonly adopted in holding and managing investment portfolios.

19. It is reckoned that there is a practice of setting up an offshore fund by incorporating a company in an overseas jurisdiction, appointing two Hong Kong fund managers as the company's only directors and granting the managers full discretion to deal in Hong Kong securities. The Department's view is that, under such a setup, the "Hong Kong based fund" with its directors and principal officers exercising central management and control of the fund in Hong Kong is no different from a normal resident company. Such a "Hong Kong based fund" is not the intended beneficiary of, and hence is not entitled to claim for, the exemption.

20. The Department would like to reiterate that adopting the "central management and control" test for the purposes of the exemption will not impose any new tax liabilities on a "Hong Kong based fund". Before the implementation of the exemption, a "Hong Kong based fund" was chargeable to tax in respect of its trading profits derived from Hong Kong, but not offshore profits or capital gains. The "central management and control" test will not alter this position. Even if a "Hong Kong-based fund" is determined to be a resident person by the "central management and control" test, and hence does not qualify for the exemption, it will only continue to be chargeable to tax in respect of its Hong Kong trading profits, and not offshore profits or capital gains. The Exemption Provisions only exempt profits which are otherwise chargeable to tax. They are not a new charging section and do not affect the existing territorial source principle of taxation.

Split year residence

21. Funds or other entities may change their residence during a year of assessment (i.e. from a non-resident person to a resident person or vice versa). Whilst cases of this type should be rare, the residence of the fund concerned will be determined on a year of assessment basis by reference to the respective

periods during which the fund is a resident or non-resident of Hong Kong. For a fund which is newly set up during a year of assessment, its residence will be determined by reference to the period from its set-up date to the end of the year of assessment.

THE EXEMPTION PROVISIONS

Exemption criteria

22. The Exemption Provisions are contained in section 20AC. Generally speaking, to qualify for the exemption, a person has to satisfy the following conditions:

- (a) the person is a non-resident person;
- (b) the specified transactions are carried out through or arranged by a specified person or the person is a qualifying fund; and
- (c) the person does not carry on any trade, profession or business in Hong Kong involving transactions other than the specified transactions and transactions incidental to the carrying out of the specified transactions. Specifically, the person is not permitted to engage in the following activities (which are not exhaustive) in Hong Kong:
 - (i) property development or property holding;
 - (ii) finance (banking, providing capital, leasing, factoring or securitization);
 - (iii) insurance;
 - (iv) construction or acquisition of infrastructure facilities;
or
 - (v) making investments that derive rent, royalties or lease payments.

Scope of Exemption

23. A person eligible for the exemption is exempt from profits tax in respect of the profits derived from the specified transactions. The exemption also covers profits derived from the incidental transactions provided that the trading receipts from the incidental transactions do not exceed 5% of the total trading receipts from both the specified transactions and the incidental transactions. If the 5% threshold is exceeded, the whole trading receipts from the incidental transactions will be chargeable to profits tax. However, profits from the specified transactions will remain fully exempt.

Specified Transactions

24. Specified transactions are broadly defined in the Ordinance to cover typical transactions carried out by offshore funds in Hong Kong. Schedule 16 to the Ordinance contains the list of specified transactions which include six categories of transactions:

- (a) a transaction in securities;
- (b) a transaction in futures contracts;
- (c) a transaction in foreign exchange contracts;
- (d) a transaction consisting in the making of a deposit other than by way of a money-lending business;
- (e) a transaction in foreign currencies; and
- (f) a transaction in exchange-traded commodities.

Appendix B sets out the Department's views on whether particular transactions are covered by the specified transactions. It should be emphasised that the holding of debentures, loan stocks, bonds or notes to earn "interest income" is not a transaction in securities since such holding does not involve two transacting parties and cannot be regarded as a transaction. The interest derived therefrom could only be considered as derived from incidental transactions and not specified transactions.

25. To cater for changes in the financial products traded in the market, the Commissioner is empowered under section 20AC(5) to amend Schedule 16 by notice published in the Gazette.

Transaction in securities

26. Prior to the enactment of the 2015 Ordinance, “securities” was defined to mean:

- (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; and
- (e) interests, rights or property, whether in the form of an instrument or otherwise, commonly known as securities,

but does not include shares or debentures of, or rights, options or interests (whether described as units or otherwise) in, or in respect of, shares or debentures of, a company that is a private company within the meaning of section 11 of the Companies Ordinance (Cap. 622)².

27. Schedule 16 also contains definitions of “collective investment scheme”, “debenture” and “share” in relation to the meaning of “securities”.

² Under section 11 of the Companies Ordinance (Cap. 622), “private company” means a company which by its articles - (a) restricts the right to transfer its shares; and (b) limits the number of its members to 50, not including persons who are in the employment of the company and persons who, having been formerly in the employment of the company, were while in that employment, and have continued after the determination of that employment to be, members of the company; and (c) prohibits any invitation to the public to subscribe for any shares or debentures of the company.

28. The 2015 Ordinance has modified the definition of “securities” so that profits tax exemption can be extended to transactions in shares, stocks, debentures, loan stocks, funds, bonds or notes of a private company which is an SPV or an excepted private company and the related rights, options, or certificate of interest, etc. The extended profits tax exemption applies to specified transactions carried out from 1 April 2015 onwards. In this context, “private company” is defined to mean a company incorporated in or outside Hong Kong that is not allowed to issue any invitation to the public to subscribe for any shares or debentures of the company.

Transaction in futures contracts

29. “Futures contract” is defined to mean:

- (a) a contract or an option on a contract that is listed or traded on the Hong Kong Futures Exchange Limited; or
- (b) any other contract for differences-
 - (i) that is listed on a specified stock exchange, or traded on a specified futures exchange, within the meaning of section 1 of Part 1 of Schedule 1 to the SFO (see **Appendix C**);
 - (ii) that an authorized institution within the meaning of the Banking Ordinance (BO) (Cap. 155) may enter into under that ordinance; or
 - (iii) the transaction in respect of which is regulated by or under, or is carried out in compliance with, the SFO.

30. “Contract for differences” is defined to mean an agreement the purpose or effect of which is to obtain a profit or avoid a loss by reference to fluctuations in the value or price of property of any description or in an index or other factor designated for that purpose in the agreement. In general terms, a contract for differences is a contract which rides on the differences in the value of the underlying property or index, which is commonly used for hedging purposes in the financial market. It covers a wide range of contracts,

including the common types of financial derivatives traded by offshore funds (e.g. cash-settled commodity futures contract, Hang Seng Index futures contract, etc.).

31. The definition of “futures contract” covers contracts for differences that may be properly carried out through a specified stock exchange or a specified futures exchange, as well as those entered into by an authorized institution under the BO and those that are regulated by or carried out in compliance with the SFO.

Transaction in foreign exchange contracts

32. “Foreign exchange contract” is defined to mean a contract other than a futures contract and an options contract, whereby the parties to the contract agree to exchange different currencies *at a future time*. It covers both leveraged and non-leveraged foreign exchange transactions. The transactions may involve entirely foreign currencies, or foreign currencies and Hong Kong dollars. Spot transactions in foreign currencies are discussed in paragraph 34 below.

Transaction consisting in the making of a deposit other than by way of a money-lending business

33. “Deposit” is defined to mean a loan of money (a) at interest; or (b) repayable at a premium or repayable with any consideration in money or money’s worth. Offshore funds in the normal course of business may hold money deposits in their asset portfolios. This type of specified transaction covers the holding of such money deposits, which may be in any currency, by offshore funds. As clearly provided, this type of specified transaction does not cover cases where a person makes deposits in the ordinary course of carrying on a money-lending business. The term “money-lending business” is not defined and would be accorded its ordinary meaning. It is a question of fact whether a money-lending business is carried on. In the context of the Ordinance, it has been decided in tax cases that in determining if a money-lending business is carried on, whether there is a money-lender’s licence granted under other ordinances is not conclusive. See *Shun Lee Investment Co., Ltd. v CIR*, 1 HKTC 322 and Board of Review Decision D38/89, IRBRD vol 4, 433.

Transaction in foreign currencies

34. “Transaction in foreign currencies” covers spot transactions in foreign currencies (transactions in exchanging currencies at a future time are covered by “transaction in foreign exchange contracts” - see paragraph 32) and transactions in exchanging foreign currencies from or to Hong Kong dollars.

Transaction in exchange-traded commodities

35. “Exchange-traded commodity” is defined to mean gold or silver traded on a commodity exchange in Hong Kong to which the Commodity Exchanges (Prohibition) Ordinance (CEPO) (Cap. 82) does not apply by virtue of section 3(d) of that ordinance. The CEPO in general prohibits the operation of commodity exchanges in Hong Kong with the exception of those provided in section 3 thereof. Section 3(d) refers to a commodity exchange which was in operation on 20 June 1973. The Chinese Gold & Silver Exchange Society is a commodity exchange in Hong Kong to which the CEPO does not apply by virtue of section 3(d). This type of specified transaction therefore covers transactions in gold or silver traded on the Chinese Gold & Silver Exchange Society.

Incidental transactions

36. An offshore fund may carry out transactions in Hong Kong which are not specified transactions but incidental to the carrying out of the specified transactions. Under the Exemption Provisions, incidental transactions will not be regarded as “any other business” carried on in Hong Kong. An offshore fund still qualifies for the exemption even if it carries out incidental transactions in the relevant year of assessment. Subject to a 5% threshold, tax exemption is to be allowed in respect of the profits derived from the incidental transactions. The 5% threshold refers to the situation where the trading receipts from the incidental transactions do not exceed 5% of the total trading receipts from the specified transactions and the incidental transactions taken together. If the 5% threshold is exceeded, the whole trading receipts from the incidental transactions (i.e. not just the amount in excess of the 5% threshold) will be chargeable to profits tax. Profits derived from the specified transactions, however, will remain fully exempt from tax.

37. The term “incidental transaction” is not defined. The word “incidental” will be accorded its common meaning³, which should cover the various modes of operation of different offshore funds. Whether particular transactions carried out by an offshore fund are “incidental transactions” is a question of fact, which can only be determined by reference to the particular mode of operation of the offshore fund concerned. Typical incidental transactions include custody of securities, and receipts of interest or dividend on securities acquired through the specified transactions.

38. “Trading receipts” for the purposes of applying the 5% threshold mean gross receipts that should have been chargeable to tax but for the exemption. Hence, receipts that all along are non-taxable without relying on the Exemption Provisions (e.g. tax-exempt dividends or interest income) are excluded in applying the 5% threshold.

Example 1

A-Fund Limited was a non-resident company. It had the following business receipts in the year of assessment 2014/15:

	\$
<i>Dividends from Hong Kong listed companies</i>	<i>300,000</i>
<i>Receipts from other incidental transactions</i>	<i>260,000</i>
<i>Receipts from specified transactions</i>	<i>5,000,000</i>

The 5% threshold was applied by reference to the “receipts from other incidental transactions” and the “receipts from specified transactions”. The dividends, all along tax-exempt, were not be taken into account. As the “receipts from other incidental transactions” only represent 4.94% of the total receipts (i.e. $\$260,000 \div (\$5,000,000 + \$260,000)$), the “receipts from other incidental transactions” together with the “receipts from specified transactions” were exempt from profits tax under section 20AC.

³ According to the Shorter Oxford English Dictionary (sixth edition), “incidental” means “liable to happen to; naturally attaching to; occurring as something casual or of secondary importance; not directly relevant to; following (up)on as a subordinate circumstance”.

If the dividends had been taken into account, the percentage of “receipts from incidental transactions” would have become 10.07% (i.e. $(\$300,000 + \$260,000) \div (5,000,000 + 300,000 + 260,000)$), which exceeds the 5% threshold. However, such computation would be wrong as explained in paragraph 38 above.

Example 2

Same facts as those in Example 1, but the amount of the “receipts from other incidental transactions” was \$270,000.

As the 5% threshold had been exceeded (i.e. $\$270,000 \div (\$5,000,000 + \$270,000) = 5.12\%$), the “receipts from other incidental transactions” of \$270,000 were chargeable to profits tax. The “receipts from specified transactions”, however, remained tax-exempt under section 20AC.

Specified person

39. Tax exemption is allowed in respect of profits derived by the non-resident person from specified transactions if: (a) the specified transactions have been carried out through or arranged by a “specified person”; or (b) the non-resident person is a qualifying fund. The words “arranged by” cover cases where a specified transaction is not carried out by a specified person but arranged by the specified person to be carried out by another person. For example, the fund manager of an offshore fund, who is a specified person, can arrange to buy/sell stocks traded on the Tokyo Stock Exchange through an intermediary in Tokyo. A specified person normally is a corporation licensed or an authorized financial institution registered under the SFO for carrying on a business in any regulated activity as defined by Part 1 of Schedule 5 to the SFO⁴.

⁴ Schedule 5 to the SFO stipulates the following regulated activities -
Type 1 : dealing in securities;
Type 2 : dealing in futures contracts;
Type 3 : leveraged foreign exchange trading;
Type 4 : advising on securities;
Type 5 : advising on futures contracts;
Type 6 : advising on corporate finance;
Type 7 : providing automated trading services;
Type 8 : securities margin financing;
Type 9 : asset management;
Type 10 : providing credit rating services.

40. The SFO came into operation on 1 April 2003. Before the enactment of the SFO, a “specified person” licensed to carry out the specified transactions should include a dealer, an investment adviser, a commodity trading adviser, etc. licensed or registered under certain repealed ordinances. To apply the Exemption Provisions retrospectively from 1 April 1996, a specified person in relation to a specified transaction carried out before 1 April 2003 was defined to mean-

- (a) a bank as defined by section 2(1) of the BO;
- (b) a person registered as a dealer or commodity trading adviser under Part IV of the Commodities Trading Ordinance (Cap. 250) repealed under section 406 of the SFO;
- (c) a person registered as a dealer or an investment adviser under Part VI, or as a securities margin financier under Part XA, of the Securities Ordinance (Cap. 333) repealed under section 406 of the SFO; or
- (d) a person licensed as a leveraged foreign exchange trader under Part IV of the Leveraged Foreign Exchange Trading Ordinance (Cap. 451) repealed under section 406 of the SFO.

Loss from exempt transactions

41. Profits from the specified transactions are exempt from tax. As a matter of symmetry, losses sustained by a tax-exempt offshore fund from the specified transactions in a year of assessment are not available for set off against any of its assessable profits for any subsequent years of assessment. In fact, this treatment is similar to that for offshore profits and capital gains. Since Hong Kong does not tax offshore profits or capital gains, offshore or capital losses are not allowed to set off against a person’s assessable profits.

Effective date

42. The Exemption Provisions applied with retrospective effect from the year of assessment commencing on 1 April 1996. The 2015 Ordinance extended the profits tax exemption to cover transactions in securities of an SPV or excepted private company, carried out from 1 April 2015 onwards.

THE DEEMING PROVISIONS

General

43. The exemption is intended for non-resident persons only. The Deeming Provisions are enacted to prevent abuse, or round-tripping, by resident persons disguised as non-resident persons to take advantage of the exemption. A resident person who, alone or jointly with his associates, holds direct and/or indirect beneficial interest of 30% or more in a tax-exempt offshore fund, or any percentage if the offshore fund is the resident person's associate, will be deemed to have derived assessable profits in respect of:

- (a) the trading profits earned by the offshore fund from specified transactions and incidental transactions carried out in Hong Kong under section 20AE; and
- (b) the trading profits earned by the SPV from transactions in securities of an interposed SPV or of an excepted private company under section 20AF.

The application of the Deeming Provisions would not by itself alone render the resident person to be deemed to be carrying on a business in respect of his other activities. The amount of deemed profits is ascertained by taking into account the percentage of the resident person's beneficial interest in the offshore fund and the length of ownership within the relevant year of assessment.

44. Section 20AB sets out the definitions of "direct beneficial interest" and "indirect beneficial interest".

Direct beneficial interest

45. Section 20AB(4) provides that a person is to be regarded as having a direct beneficial interest in a corporation, a partnership, a trustee of a trust estate or any other entity if:

- (a) he holds any of the issued share capital (however described) of the corporation (where the corporation is not a trustee of a trust estate);

- (b) he, as a partner in the partnership, is entitled to any of the profits of the partnership (where the partnership is not a trustee of a trust estate); or
- (c) he, otherwise than through another person -
 - (i) benefits under the trust estate; or
 - (ii) not being a trustee of the trust estate (or a director of the trustee where the trustee is a corporation), is able or might reasonably be expected to be able to control the activities of the trust estate or the application of its corpus or income;
- (d) he has any of the ownership interests in the entity which is not a corporation, a partnership and a trustee of a trust estate.

46. In Schedule 15 to the Ordinance, the extent of a person's direct beneficial interest in a corporation, a partnership or a trustee of a trust estate is defined to mean:

- (a) the percentage of the issued share capital (however described) of the corporation held by the person;
- (b) the percentage of the profits of the partnership to which the person is entitled; or
- (c) the percentage in value of the trust estate in which the person is interested.

47. The following specific provisions apply in ascertaining the extent of a person's direct beneficial interest in a corporation or a partnership.

- (a) A fund manager of a fund corporation may hold non-profit participating shares for the sole purpose of managing the fund corporation. To apply the Deeming Provisions fairly to a fund manager or other persons holding such non-profit participating shares, the shares comprised in the issued share

capital of a corporation that do not entitle their holders to receive dividends, whether in cash or in kind, and a distribution of the corporation's assets upon its dissolution (other than a return of capital) are excluded according to section 20AB(9) in computing the percentage of the issued share capital of the corporation held by a person.

Example 3

B-Fund Limited had 10,000 issued shares, out of which 500 shares were "management shares" which entitled their holders to special management rights but not dividends or distributions of assets upon dissolution. L Limited, a resident fund management company, was appointed as B-Fund Limited's fund manager and the 500 "management shares" were allotted to it. L Limited also acquired further 1,500 issued shares of B-Fund Limited.

The extent of L Limited's direct beneficial interest in B-Fund Limited was computed as $1,500 \div (10,000 - 500) = 15.79\%$. The 500 "management shares" were excluded in ascertaining its beneficial interest in the fund.

- (b) In computing the percentage of the profits of a partnership to which a person is entitled, if the person is not entitled to the partnership's profits but entitled to a distribution of the partnership's assets upon its dissolution, a reference to the entitlement to the partnership's profits is to be construed according to section 20AB(8) as a reference to the entitlement to a distribution of the partnership's assets upon its dissolution.

Indirect beneficial interest

48. Section 20AB(5) provides that a person is to be regarded as having an indirect beneficial interest in a corporation, a partnership, a trustee of a trust estate or any other entity if, through an interposed person or a series of two or more interposed persons:

- (a) he is interested in any of the issued share capital (however described) of the corporation (where the corporation is not a trustee of a trust estate);
- (b) he is entitled to any of the profits of the partnership (where the partnership is not a trustee of a trust estate); or
- (c) he -
 - (i) benefits under the trust estate; or
 - (ii) not being a trustee of the trust estate (or a director of the trustee where the trustee is a corporation), is able or might reasonably be expected to be able to control the activities of the trust estate or the application of its corpus or income;
- (d) he has any of the ownership interests in the entity which is not a corporation, a partnership and a trustee of a trust estate.

49. A person has an indirect beneficial interest in a corporation, a partnership, a trustee of a trust estate or any other entity, if he has a direct beneficial interest in the first interposed person and the first interposed person has a direct beneficial interest in the next interposed person and so on, and the last interposed person has a direct beneficial interest in the corporation, the partnership or the trustee of the trust estate.

50. The extent of a person's indirect beneficial interest in a corporation, a partnership, a trustee of a trust estate or any other entity is arrived at by multiplying the percentage of the person's beneficial interest in the first interposed person by the percentage of the first interposed person's beneficial interest in the next interposed person and so on, and finally by the last interposed person's beneficial interest in the corporation, the partnership, the trustee of the trust estate or any other entity.

Control of a trust estate

51. A person who has the control of the activities of a trust estate can distribute the trust estate's income or asset according to his discretion and to whomever he chooses including himself. To counteract opportunities for tax-avoidance, a person who has a direct or indirect beneficial interest in a trustee of a trust estate by reason of the fact that he is able or might reasonably be expected to be able to control the activities of the trust estate or the application of its corpus (i.e. capital) or income, is to be regarded as being interested in 100% in value of the trust estate per sections 20AE(5) and 20AF(4).

Associate

52. In administering the Deeming Provisions, provisions on "associate" are required to prevent resident persons from circumventing the Deeming Provisions by holding beneficial interests in offshore funds through associates. Under section 20AE(2), beneficial interests in an offshore fund held by a resident person's associates, resident or non-resident, will be taken into account in determining whether the "30% or more" threshold is exceeded. Besides, in the case where a resident person holds a beneficial interest in a tax-exempt offshore fund which is his associate, the Deeming Provisions will apply, per sections 20AE(3) and 20AF(2), in respect of *any* percentage of the resident person's beneficial interest in the offshore fund. The adopted definition of "associate" and the related definitions of "associated corporation", "control", "principal officer" and "relative" in section 20AE(10) have been repealed by the 2015 Ordinance and placed in section 20AC(6) such that the definitions are applicable to the Exemption Provisions and Deeming Provisions.

53. Specific provisions on "associate" apply where the resident person is a natural person, a corporation or a partnership. Broadly speaking, in respect of a resident person who is a natural person, "associate" generally includes his "relative" and a corporation controlled by him. In respect of a resident person which is a corporation, "associate" generally includes its "associated corporation", which is defined to mean a corporation over which the resident corporation has control, a corporation which has control over the resident corporation, or a corporation which is under the control of the same person as the resident corporation. In respect of a resident person which is a partnership,

“associate” generally includes a partner of and a corporation controlled by the resident partnership. The 2015 Ordinance has also modified the definition of “associate” to cover the following persons-

- (a) if it is a corporation, a partnership in which the corporation is a partner; and
- (b) if it is a partnership, an “associated partnership” of the partnership.

The term “associated partnership” is defined to mean a partnership over which the resident partnership has control, a partnership which has control over the resident partnership, or a partnership which is under the control of the same person as the resident partnership.

54. For the purposes of sections 20AC, 20AE and 20AF, where a resident person holds beneficial interest in a tax-exempt offshore fund which is a partnership, the Department adopts the position that the mere fact that the resident person is a partner in the offshore fund and the other partners in the offshore fund are fellow partners of the resident person would not render the offshore fund or the other partners in the offshore fund “associates” of the resident person.

Examples on applying the Deeming Provisions by reference to beneficial interests

55. The following examples illustrate when the Deeming Provisions will apply by reference to a resident person’s beneficial interest in a tax-exempt offshore fund.

- (a) **Both direct and indirect beneficial interests are taken into account**

Example 4

M Limited, a resident company, directly held 20% and, through other companies, indirectly held 15% of the issued shares of C-Fund Limited, a tax-exempt offshore fund.

The Deeming Provisions applied to M Limited. M Limited's direct and indirect beneficial interests in C-Fund Limited (i.e. $20\% + 15\% = 35\%$) exceeded the "30% or more" threshold. 35% of the exempt profits of C-Fund Limited would be deemed to be the assessable profits of M Limited.

(b) Beneficial interests held by associates are taken into account

Example 5

N Limited and O Limited were resident companies. They were fellow subsidiaries of the same holding company. N Limited and O Limited respectively held 20% and 25% of the issued shares of D-Fund Limited, a tax-exempt offshore fund.

N Limited and O Limited were associates as they were under the control of the same company. As their beneficial interests in D-Fund Limited in total exceeded the "30% or more" threshold (i.e. $20\% + 25\% = 45\%$), the Deeming Provisions were applicable to both of them. Deemed assessable profits were ascertained by reference to the respective percentages of their beneficial interests in D-Fund Limited. Hence, 20% and 25% of the exempt profits of D-Fund Limited were deemed to be the assessable profits of N Limited and O Limited respectively.

Example 6

Same facts as those in Example 5, but O Limited was a non-resident company.

The Deeming Provisions were not applicable to O Limited, which was a non-resident company. The Deeming Provisions continued to be applicable to N Limited as its beneficial interest together with that of O Limited (though it is a non-resident company) in D-Fund Limited exceeded the

“30% or more” threshold. 20% of the exempt profits of D-Fund Limited would be deemed to be the assessable profits of N Limited. O Limited did not have any tax liability since the Deeming Provisions were not to be applied to a non-resident.

- (c) **The Deeming Provisions will apply in respect of any percentage of beneficial interests held in an offshore fund which is an associate of a resident person**

Example 7

P Limited, a resident company, held 20% of the issued shares of E-Fund Limited, a tax-exempt offshore fund and an associate of P Limited.

Although the beneficial interest held by P Limited was less than 30%, the Deeming Provisions would continue to apply since it held some beneficial interest in E-Fund Limited which was its associate.

Ascertainment of deemed profits

56. The amount of deemed assessable profits imposed on a resident person for a year of assessment is ascertained in accordance with Schedule 15 to the Ordinance. The amount of deemed assessable profits will be the total sum by adding up the amount ascertained by the formula in paragraph 57 for each day in the period during which the resident person has the following percentage of direct and/or indirect beneficial interest in the tax-exempt offshore fund:

- (a) alone or jointly with his associates, 30% or more; or
- (b) any percentage if the offshore fund is the resident person’s associate.

57. Part 1 of Schedule 15 sets out the following formula in ascertaining the amount of exempt profits of an offshore fund (which is the amount of the

deemed assessable profits of the resident person) for a particular day in a year of assessment:

$$A = \frac{B \times C}{D}$$

- where :
- A means the exempt profits of the offshore fund for a particular day in a year of assessment
 - B means the extent of the resident person's beneficial interest in the offshore fund on that particular day
 - C means the exempt profits of the offshore fund for the accounting period in which the particular day falls
 - D means the total number of days in the accounting period of the offshore fund in which the particular day falls

Appendix D contains an example on how the deemed assessable profits are ascertained for a resident person who holds an indirect beneficial interest in a tax-exempt offshore fund through a number of interposed persons.

58. The following examples elaborate some salient points in ascertaining the deemed assessable profits.

- (a) **Only days to which the Deeming Provisions apply need be included in computing the deemed assessable profits for a year of assessment**

Example 8

On 1 October 2014, Q Limited, a resident company, purchased 20% of the issued shares of F-Fund Limited, a tax-exempt offshore fund. F-Fund Limited was not Q Limited's associate. Q Limited and its associates had no other beneficial interest in F-Fund Limited. On 1 January 2015, Q Limited purchased further 30% of the issued shares of F-Fund Limited. F-Fund Limited closed its accounts on

31 March each year. During the year ended 31 March 2015, F-Fund Limited derived assessable profits of \$8m from the specified transactions.

The deemed assessable profits of Q Limited for the year of assessment 2014/15 was computed as: $\$8m \times 50\% \times (90 \text{ days} \div 365 \text{ days}) = \$0.99m$. “90 days” should refer to the period from 1 January 2015 to 31 March 2015 and “365 days” to the year ended 31 March 2015. The period from 1 October to 31 December 2014 during which Q Limited only held a beneficial interest of 20% (i.e. less than 30%) in F-Fund Limited were not to be taken into account.

(b) The tax-exempt offshore fund adopts an accounting date other than 31 March

Example 9

G-Fund Limited, a tax-exempt offshore fund, adopted 31 December as its accounting date. It derived assessable profits of \$10m and \$12m from the specified transactions respectively for the years ended 31 December 2014 and 2015. R Limited, a resident company, held 50% of the issued shares of G-Fund Limited during the period from 1 October 2014 and 30 September 2015.

Ascertainment of deemed assessable profits was made by reference to the year of assessment from 1 April to 31 March irrespective of the accounting date of the tax-exempt offshore fund. The deemed assessable profits for R Limited were computed as follows:

Year of assessment 2014/15: $\$10m \times 50\% \times (92 \text{ days} \div 365 \text{ days}) + \$12m \times 50\% \times (90 \text{ days} \div 365 \text{ days}) = \$1.26m + \$1.48m = \$2.74m$. (“92 days” referred to the period from 1 October to 31 December 2014 and “90 days” to 1 January to 31 March 2015.)

Year of assessment 2015/16: $\$12\text{m} \times 50\% \times (183 \text{ days} \div 365 \text{ days}) = \3.01m . (“183 days” referred to the period from 1 April to 30 September 2015.)

(c) The resident person adopts an accounting date other than 31 March

Example 10

Same facts as those in Example 9. R Limited adopted 30 June as its accounting date.

The deemed assessable profits for R Limited for the years of assessment 2014/15 and 2015/16 would be ascertained on the same basis as that in Example 9 irrespective of the accounting date adopted by R Limited. See paragraph 66 below on how R Limited should report the deemed assessable profits in its profits tax returns.

(d) Non-taxable items not to be taken into account in ascertaining deemed assessable profits

Example 11

H-Fund Limited, a tax-exempt offshore fund, derived assessable profits of \$20m from the specified transactions for its accounting year ended 31 March 2015. During the same year, it also received dividends of \$1m from a Hong Kong listed company and interests of \$2m on a long term debt instrument (within the meaning of section 26A of the Ordinance). S Limited, a resident company, held 50% of the issued shares of H-Fund Limited during the year ended 31 March 2015.

The deemed assessable profits for S Limited for the year of assessment 2014/15 was $\$20\text{m} \times 50\% = \10m . The non-taxable items (i.e. dividends of \$1m and interests of \$2m) should not be included in computing the deemed assessable profits.

(e) **Expenses incurred by the resident in generating deemed assessable profits are not deductible**

Example 12

Same facts as those in Example 11. S Limited incurred general administration expenses of \$1m during the year ended 31 March 2015 and sought to deduct such expenses against the deemed assessable profits.

Deduction in respect of the administration expenses could not be allowed. Any expenses incurred by H-Fund Limited in earning the profits from the specified transactions would have been deducted in ascertaining H-Fund's assessable profits, which were deemed to be the assessable profits of S Limited.

No deemed loss for resident persons

59. The policy objective of the exemption is to attract foreign capital to invest in the local market. The Deeming Provisions are intended disincentives to resident persons for taking advantage of the exemption by carrying out round-tripping. In this regard, the Deeming Provisions only impose deemed profits but not losses on a resident person. A resident person, therefore, will not be entitled to claim any proportionate amount of the losses sustained by a tax-exempt offshore fund in which he holds a beneficial interest.

60. A resident person may sustain losses in other businesses carried on in Hong Kong for the relevant year of assessment. Section 20AE provides that the deemed assessable profits "are to be regarded as the assessable profits arising in or derived from Hong Kong of the resident person for that year of assessment from a trade, profession or business carried on by the resident person in Hong Kong." Whether a resident person can set off the deemed assessable profits, like those derived from a normal trade, profession or business, by losses sustained in its/his other businesses in accordance with the provisions of section 19C depends on its/his status. In the case of a resident corporation, the set-off is allowable. In the case of a resident individual or resident partnership, the set-off is not allowable, unless the holding of the beneficial interest in the offshore fund is part and parcel of his/its other

business. The individual or partners of the partnership can, however, obtain the set-off under personal assessment, if applicable.

Deeming Provisions not to apply in certain circumstances

61. It will be unlikely for a resident person to carry out round-tripping by holding a beneficial interest in an offshore fund that is bona fide widely held by investors. On this consideration, the Deeming Provisions do not apply to a resident person if the Commissioner is satisfied under section 20AE(8) that beneficial interests in the offshore fund concerned are bona fide widely held.

62. The term “bona fide widely held”, which also appears in section 26A(1A), is not defined in the Ordinance. In the context of section 26A(1A), the Departmental Interpretation and Practice Notes No. 20 (Revised) (“Mutual Funds, Unit Trusts, and Similar Investment Schemes”) (DIPN 20) states that the “bona fide widely held” requirement is satisfied if, during the year of assessment in question, at no time did fewer than 50 persons hold (or have the right to become the holders of) all of the units or shares in the scheme and at no time during the year did fewer than 21 persons hold (or have the right to become the holders of) units or shares that entitled the holders, directly or indirectly, to 75%, or more, of the income or property of the scheme.

63. Where the above benchmark figures are not met, it will still be accepted in practice that the requirement has been satisfied if it is clear from the constitutive documents of the scheme and other relevant material that it was established with a view to wide public participation and that genuine efforts are being taken with the aim of achieving that objective (i.e. there is nothing to suggest that the scheme is intended to be a closely held investment vehicle). This situation could arise, for example, where a scheme has only recently been established or where, despite the wishes of the parties concerned, it has proved to be unpopular with investors. The Department considers that, for the purposes of section 20AE(8), “bona fide widely held” should adopt the same practice as stated in DIPN 20.

64. A resident person may hold indirect beneficial interest in an offshore fund through interposed persons who are also resident persons. In the absence of any specific provisions, the Deeming Provisions will separately apply to the resident person and the interposed resident persons. Double taxation of

deemed assessable profits by reference to the profits of the same offshore fund would thus arise. To avoid this anomaly, section 20AE(9) specifically provides that a resident person is not liable to tax in respect of the deemed assessable profits if any of the interposed resident persons through whom he holds an indirect beneficial interest in an offshore fund is liable to tax under the Deeming Provisions in respect of the assessable profits of the same offshore fund.

Example 13

T Limited held 90% of the issued shares of U Limited which in turn held 70% of the issued shares of V Limited. V Limited held 50% of the issued shares of I-Fund Limited, a tax-exempt offshore fund. T Limited, U Limited and V Limited were all resident companies.

Under the Deeming Provisions, deemed assessable profits representing 50% of the exempt profits of I-Fund Limited would be attributed to V Limited.

Under section 20AE(9), no deemed assessable profits would be attributed to T Limited and U Limited notwithstanding that they both hold indirect beneficial interests of more than 30% (T Limited: $90\% \times 70\% \times 50\% = 31.5\%$; U Limited: $70\% \times 50\% = 35\%$) in I-Fund Limited. Deemed assessable profits in respect of the same exempt profits of I-Fund Limited had already been imposed on V Limited.

Reporting requirements

65. Section 20AE imposes tax liabilities on a resident person in respect of the deemed assessable profits. As with other persons chargeable to tax, the resident person bears the legal obligation of complying with other provisions of the Ordinance on reporting chargeability, lodgment of returns, providing information, payment of tax, etc. Penalties under Part 14 of the Ordinance may be imposed for failures to comply with the relevant statutory provisions.

66. Examples 9 and 10 above set out that the amount of deemed assessable profits is to be computed on a year of assessment basis irrespective of the accounting date adopted by the tax-exempt offshore fund or the resident

person. As illustrated in the examples, a resident person may be required to report the deemed assessable profits for a year of assessment by reference to more than one set of annual accounts of the offshore fund. It is envisaged that the annual accounts of the offshore fund covering the later part of the year of assessment may not have been finalized when the resident person is required to file his tax return. In such a case, the Department accepts the arrangement that the resident person may report in his tax return for a year of assessment (which is to be filed within the normal time limit) only the amount of the deemed assessable profits attributable to the annual accounts of the offshore fund that are already closed within that year of assessment. In respect of the remaining amount of the deemed assessable profits attributable to the next annual accounts of the offshore fund, the resident person is required to report it within four months after the annual accounts closing date by way of a letter to be sent to the Department. The letter is to be treated as additional information to the resident person's tax return. Additional assessment for the relevant year of assessment will be raised on the remaining amount of deemed assessable profits as appropriate.

Example 14

Same facts as those in Example 9. Within the year of assessment 2014/15, G-Fund Limited only closed its accounts for the year ended 31 December 2014. In its profits tax return for the year of assessment 2014/15 (which should be filed within the normal time limit), R Limited should report the deemed assessable profits of \$1.26m for the period from 1 October to 31 December 2014.

Not later than 30 April 2016, R Limited should send a letter to the Department to report the deemed assessable profits of \$1.48m for the period from 1 January to 31 March 2015. An additional assessment for the year of assessment 2014/15 with additional assessable profits of \$1.48m would be raised on R Limited.

In its profits tax return for the year of assessment 2015/16 (which was to be filed within the normal time limit), R Limited should report the deemed assessable profits of \$3.01m for the period from 1 April to 30 September 2016.

67. There may be cases where a resident person relies on the information provided by an offshore fund in determining whether any deemed profits arose or in reporting an incorrect amount of deemed profits to the Department. Under the Ordinance, a taxpayer will only be imposed a penalty if he fails to perform the legal obligations “without reasonable excuse”. The Department, before imposing a penalty, would consider the whole facts and circumstances in deciding whether a resident person’s reliance on incorrect information provided by an offshore fund constitutes a reasonable excuse. Further, a resident person has the right to appeal against the penalty imposed by the Department if he does not agree with it.

Effective date

68. The Deeming Provisions under section 20AE apply from the year of assessment commencing on 1 April 2006. A resident person is required to report his deemed assessable profits for the year ended 31 March 2007 and subsequent years in his tax returns. Alternatively, if he has not already been required to furnish a return for any year of assessment in which he has deemed assessable profits, he should inform the Commissioner in writing of his chargeability within 4 months after the end of the basis period of the year of assessment concerned. The deemed assessable profits should be ascertained and reported by reference to the year ended 31 March of each year irrespective of the accounting date adopted by the tax-exempt offshore fund or the resident person.

TAX AVOIDANCE

General anti-avoidance provisions

69. The Department will generally act in accordance with this Note in providing profits tax exemption to offshore funds and administering the related issues. However, in cases where tax avoidance is involved, the Department will consider invoking the general anti-avoidance provisions under sections 61 or 61A of the Ordinance as appropriate to counteract the avoidance.

**The central management and control test
Residence of different forms of investment vehicles**

	Investor	Investment Vehicle	Management of Investment Vehicle (Note¹)	Fund Management	Taxable Entity	Residence of Taxable Entity
1.	Individual A not ordinarily or temporarily resides in Hong Kong	Funds remitted directly to HK Fund Manager	N.A.	Licensed Hong Kong Fund Manager with full discretion	Individual A (Note ²)	Non-resident
2.		Trust set up in Cayman Islands	Trustee B resides in Cayman Islands		Trustee B	
3.		Mutual Fund Corporation C set up in Cayman Islands	Board of directors in Cayman Islands		Mutual Fund Corporation C	
4.	Company D carrying on other business in London; managed by a board of directors there	Funds remitted directly to HK Fund Manager	N.A.	Licensed Hong Kong Fund Manager with full discretion	Company D	Non-resident
5.		Trust set up in Cayman Islands	Trustee E resides in Cayman Islands		Trustee E	
6.		Mutual Fund Corporation F set up in Cayman Islands	Board of directors in Cayman Islands		Mutual Fund Corporation F	
7.	Offshore investors	Private Company G incorporated in BVI	Board of directors comprising only 2 HK fund managers in HK	2 licensed Hong Kong Fund Managers (the directors) with full discretion	Company G	Resident (centrally managed and controlled in HK)

¹ In case of a company, the relevant board of directors can remove the fund manager, monitors and evaluates the fund manager's performance, and may direct the funds to be invested in other countries. In the case of a trust, the relevant trustee is legally in charge of the trust estate and ultimately responsible to the beneficiaries (i.e. unit holders). He supervises the operation of the trust to ensure compliance with the trust's constitutive documents, ensures that the fund manager complies with the investment strategy, reviews the fund manager's performance and has the power to remove the fund manager in accordance with the relevant provisions in the trust deed. The mere fact that the majority of the directors of the management board of a company (if that is the highest level of control of the business of the fund) are resident in Hong Kong would not adversely affect the residence status of the company (see paragraph 15). Neither will the mere outsourcing of back office administrative work to a service provider in Hong Kong affect the taxable entity's residence.

² The residence of an individual is based on the "ordinary or temporary residence" test and not the "central management and control" test. This example is added for the sake of completeness.

	Investor	Investment Vehicle	Management of Investment Vehicle (Note¹)	Fund Management	Taxable Entity	Residence of Taxable Entity
8.	Offshore investors	Private Company H incorporated in BVI	Board of directors comprising HK fund managers and other non-resident persons, holding majority of board meetings (through which central management and control is exercised –footnote 1) outside HK	Licensed Hong Kong Fund Managers (the directors) with full discretion	Company H	Non-resident
9.	Offshore investors	Limited partnership J set up in BVI	Non-resident general partners only; limited partners (may include resident persons) have no management rights	Licensed Hong Kong Fund Managers with full discretion	Limited partnership J	Non-Resident (centrally managed and controlled outside HK)
10.	Company K incorporated in Japan and managed by a board of directors there; deals in home appliances	Branch set up in Hong Kong – sells home appliances and deals in HK securities	Company K itself in Japan	Licensed Hong Kong Fund Manager with full discretion	Company K	Non-resident, but no exemption since selling of home appliances is a separate business
11.	Global fund Institution L incorporated and managed by a board of directors outside HK; invests in the global securities markets	A portion of the global funds remitted directly to HK Fund Manager; no investment vehicle is set up	N.A.	Licensed Hong Kong Fund Manager with full discretion	Institution L	Non-resident

Profits tax exemption for offshore funds - specified transactions

	Transaction in	Covered by specified transactions?
1	Foreign exchange/currencies	
1(a)	Foreign exchange forwards	Yes – “transaction in foreign exchange contract”. Both leveraged and non-leveraged transactions are covered.
1(b)	Foreign exchange options	Yes – “transaction in securities”– paragraph (e). Both leveraged and non-leveraged transactions are covered.
1(c)	Currency swaps	Yes – “transaction in foreign exchange contract”. Both leveraged and non-leveraged transactions are covered.
1(d)	Spot foreign exchange transactions	Yes – “transaction in foreign currencies”. Transactions of foreign currencies exchanged from/to Hong Kong dollars are covered.
1(e)	Deposits	Yes – “transaction consisting in the making of a deposit other than by way of a money-lending business”.
1(f)	Certificates of deposit, bills of exchange and promissory notes	Yes – “transaction in securities”– paragraph (e).
1(g)	Borrowing/lending money (in any currency, and whether on a secured or unsecured basis) (including participating as a lender in syndicated loans, selling sub-participations in loans to third parties, etc.)	No, if the activities amount to the carrying on of a money-lending business similar to a financial institution or a licensed money-lender. The absence of a banking or money-lending licence is not conclusive as to whether or not such a business is being carried on. The normal course of the business of an offshore fund should not include carrying on a money lending business, which is a question of fact. If the placing of funds is by way of investment, it is covered by “transaction consisting in the making of a deposit other than by way of a money-lending business”.
1(h)	Non-performing loans	Yes – “transaction in securities”– paragraph (e).

	Transaction in	Covered by specified transactions?
2	Equities	
2(a)	Listed equities (whether in Hong Kong or elsewhere)	Yes – “transaction in securities”– paragraph (a).
2(b)	Unlisted equities issued by ‘public’ companies (whether incorporated in Hong Kong or elsewhere)	Yes – “transaction in securities”– paragraph (a).
2(c)	Equities in private companies which are ‘special purpose vehicles’ or ‘excepted private companies’	Yes – “transaction in securities”– paragraph (a).
2(d)	Stock borrowing and lending and repurchase and reverse-repurchase transactions in equities	Yes – “transaction in securities”– paragraph (a).
2(e)	Hedging activities involving buying and selling equities as a hedge to some derivative or other position	Yes – “transaction in securities”– paragraph (a).
2(f)	Short selling equities (whether on market or off market)	Yes – “transaction in securities”– paragraph (a).
3	Equity derivatives	
3(a)	Exchange-traded futures contracts over equities (including equity index products)	Yes – “transaction in futures contracts”.
3(b)	Exchange-traded options on futures contracts over equities (including equity index products)	Yes – “transaction in futures contracts”.
3(c)	Exchange-traded stock option contracts over equities (including equity index products)	Yes – “transaction in futures contracts”.
3(d)	Over-the-counter (“OTC”) equity contracts for differences (whether over one or more equities)	Yes – “transaction in futures contracts” – paragraph (b).

	Transaction in	Covered by specified transactions?
3(e)	OTC call/put options over equities (physical delivery) (whether over one or more equities)	Yes – “transaction in securities”– paragraph (b).
3(f)	OTC call/put options over equities (cash settlement) (whether over one or more equities)	Yes – “transaction in futures contracts”.
3(g)	OTC forwards over equities (physical delivery) (whether over one or more equities)	Yes – “transaction in securities”– paragraph (b).
3(h)	OTC forwards over equities (cash settlement) (whether over one or more equities)	Yes – “transaction in futures contracts” – paragraph (b).
3(i)	OTC equity asset swaps, total return swaps, swaptions (whether over one or more equities)	Yes – “transaction in securities”– paragraph (b).
3(j)	Warrants (whether exchange traded or OTC)	Yes – “transaction in securities”– paragraph (b).
3(k)	OTC swaps of dividend on equities against some other income stream (whether over one or more equities)	Yes – “transaction in securities”– paragraph (e).
4	Funds	
4(a)	Funds (whether exchange traded or not)	Yes – “transaction in securities”– paragraph (a).
4(b)	Funds of funds	Yes – “transaction in securities”– paragraph (a).
4(c)	Hedge funds	Yes – “transaction in securities”– paragraph (a).
4(d)	OTC call/put options over funds (physical delivery) (whether over one or more funds)	Yes – “transaction in securities”– paragraph (b).
4(e)	OTC call/put options over funds (cash settlement) (whether over one or more funds)	Yes – “transaction in futures contracts”.

	Transaction in	Covered by specified transactions?
4(f)	OTC forwards over funds (physical delivery) (whether over one or more funds)	Yes – “transaction in securities”– paragraph (b).
4(g)	OTC forwards over funds (cash settlement) (whether over one or more funds)	Yes – “transaction in futures contracts” – paragraph (b).
5	Fixed income	
5(a)	Any listed bonds, debentures or notes (whether in Hong Kong or elsewhere) (including ‘plain vanilla’ bonds, bonds with warrants, convertible bonds, exchangeable bonds, structured notes, asset-backed securities, mortgage-backed securities)	Yes – “transaction in securities”– paragraph (a).
5(b)	Any unlisted bonds, debentures or notes issued by ‘public’ companies (whether incorporated in Hong Kong or elsewhere) (including ‘plain vanilla’ bonds, bonds with warrants, convertible bonds, exchangeable bonds, structured notes)	Yes – “transaction in securities”– paragraph (a).
5(c)	Unlisted bonds, debentures or notes issued by ‘excepted private companies’ (including ‘plain vanilla’ bonds, bonds with warrants, convertible bonds, exchangeable bonds, structured notes)	Yes – “transaction in securities”– paragraph (a).
5(d)	Stock borrowing and lending and repurchase and reverse-repurchase transactions in any bonds, debentures or notes	Yes – “transaction in securities”– paragraph (a).
5(e)	Hedging activities involving buying and selling any bonds, debentures or notes as a hedge to some derivative or other position	Yes – “transaction in securities”– paragraph (a).

	Transaction in	Covered by specified transactions?
5(f)	Short selling any bonds, debentures or notes (whether on market or off market)	Yes – “transaction in securities”– paragraph (a).
6	Fixed income derivatives	
6(a)	OTC call/put options over bonds, debentures or notes (physical delivery) (whether over one or more bonds, debentures or notes)	Yes – “transaction in securities”– paragraph (b).
6(b)	OTC call/put options over bonds, debentures or notes (cash settlement) (whether over one or more bonds, debentures or notes)	Yes – “transaction in futures contracts”.
6(c)	OTC forwards over bonds, debentures or notes (physical delivery) (whether over one or more bonds, debentures or notes)	Yes – “transaction in securities”– paragraph (b).
6(d)	OTC forwards over bonds, debentures or notes (cash settlement) (whether over one or more bonds, debentures or notes)	Yes – “transaction in futures contracts” – paragraph (b).
6(e)	OTC bond, debenture or note asset swaps, total return swaps, swaptions (whether over one or more bonds, debentures or notes)	Yes – “transaction in securities”– paragraph (b).
6(f)	OTC swaps of interest paid on bonds, debentures or notes against some other income stream (whether over one or more bonds, debentures or notes)	Yes – “transaction in securities”– paragraph (e).
6(g)	OTC credit default swaps (physical delivery of the underlying reference obligations)	Yes – “transaction in securities”– paragraph (e).
6(h)	OTC credit default swaps (cash settled)	Yes – “transaction in securities”– paragraph (e).
6(i)	Credit-linked notes (whether listed or unlisted)	Yes – “transaction in securities”– paragraph (a).

	Transaction in	Covered by specified transactions?
6(j)	Collateralised debt obligations	Yes – “transaction in securities”– paragraph (a).
7	Interest rate derivatives	
7(a)	OTC interest rate swaps (whether fixed rate v fixed rate, fixed rate v floating rate, or floating rate v floating rate)	Yes – “transaction in securities”– paragraph (e).
7(b)	OTC interest rate options, swaptions, caps, collars, floors, etc.	Yes – “transaction in futures contract” – paragraph (b).
8	Commodities	
8(a)	Commodities (physical delivery)	Yes – “transaction in exchange-traded commodities” [buying/selling gold and silver through the Hong Kong Gold and Silver Exchange Society]. Overseas transactions in exchange-traded commodities (physical delivery) would only give rise to non-taxable offshore profits.
8(b)	Exchange-traded futures contracts over commodities (including commodity index products)	Yes – “transaction in futures contracts”.
8(c)	Exchange-traded options on futures contracts over commodities (including commodity index products)	Yes – “transaction in futures contracts”.
8(d)	OTC commodity contracts for differences (whether over one or more commodities)	Yes – “transaction in futures contracts” – paragraph (b).
8(e)	OTC call/put options over commodities (physical delivery) (whether over one or more commodities)	Yes – “transaction in securities”– paragraph (e).
8(f)	OTC call/put options over commodities (cash settlement) (whether over one or more commodities)	Yes – “transaction in futures contracts”.

	Transaction in	Covered by specified transactions?
8(g)	OTC forwards over commodities (physical delivery) (whether over one or more commodities)	Yes – “transaction in securities”– paragraph (e).
8(h)	OTC forwards over commodities (cash settlement) (whether over one or more commodities)	Yes – “transaction in futures contracts” – paragraph (b).
8(i)	OTC commodity asset swaps, total return swaps, swaptions (whether over one or more commodities)	Yes – “transaction in securities”– paragraph (e).
9	Other derivatives	
9(a)	Insurance policies	No, not covered by the specified transactions. An insurance policy is presently not an investment “commonly known as securities”.
9(b)	OTC energy derivatives (e.g. over electricity supply/capacity)	Yes - “transaction in securities” – paragraph (e), if there is physical delivery of the electricity supply. Otherwise covered by “transaction in futures contracts” – paragraph (b).
9(c)	OTC weather derivatives	Yes – “transaction in futures contracts” – paragraph (b).
9(d)	OTC freight derivatives	Yes – “transaction in futures contracts” – paragraph (b). May also be covered by “transaction in securities” – paragraph (e), if there is physical delivery.
9(e)	OTC derivatives over insurance policies	No, not covered by the specified transactions. See item 9(a) above.
9(f)	OTC derivatives over inflation rates and economic statistics	Yes – “transaction in futures contracts” – paragraph (b).
9(g)	Derivatives on derivatives	Yes – “transaction in securities”– paragraph (e).

Notes : Unless otherwise stated, all shares, stocks, bonds, debentures, notes or other equities are not those in, or in respect of, private companies other than ‘special purpose vehicles’ and ‘excepted private companies’.

Paragraphs mentioned in the right-hand column refer to the paragraphs of the definitions of the relevant specified transactions stipulated in section 1 of Part 2 of Schedule 16.

Specified stock exchanges and specified futures exchanges within the meaning of section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571) per Legal Notice 94 of 2012 are as follow:

SPECIFIED FUTURES EXCHANGES

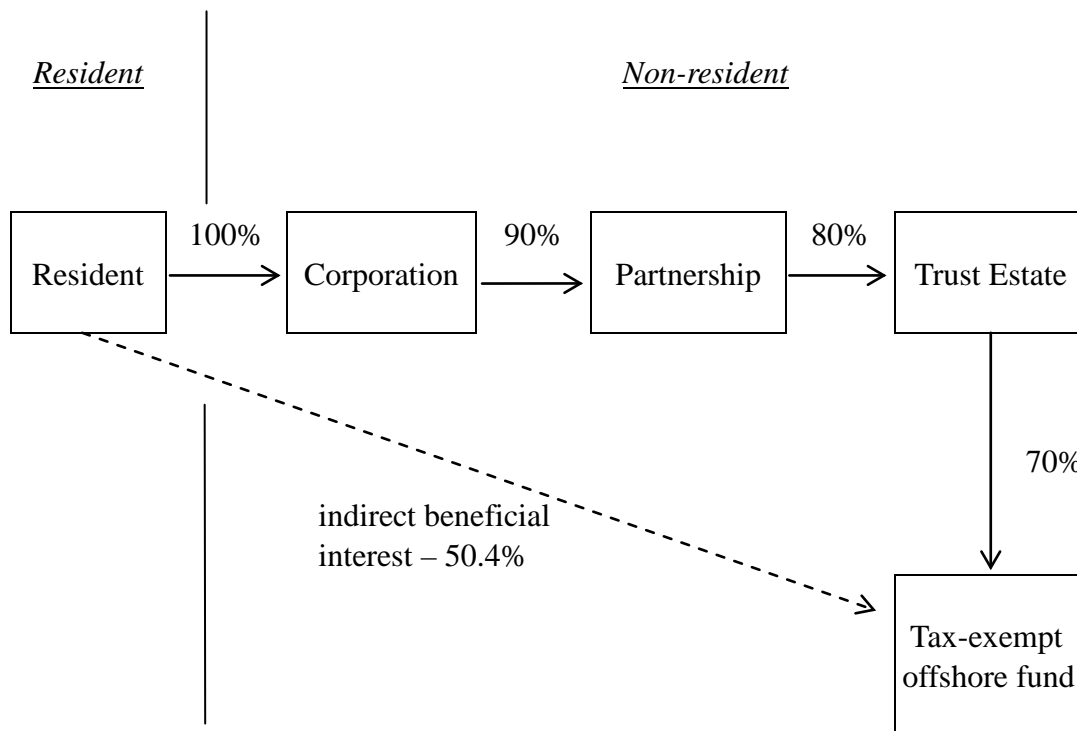
1. ASX Limited
2. Australian Securities Exchange Limited
3. BM&FBOVESPA S.A. – Bolsa de Valores, Mercadorias e Futuros
4. Board of Trade of the City of Chicago, Inc.
5. Chicago Board Options Exchange, Incorporated
6. Chicago Mercantile Exchange Inc.
7. China Financial Futures Exchange
8. Commodity Exchange, Inc.
9. Dalian Commodity Exchange
10. Eurex Frankfurt AG
11. Eurex Zürich AG
12. Euronext Amsterdam N.V.
13. Euronext Paris S.A.
14. Hong Kong Futures Exchange Limited
15. ICE Futures Canada, Inc.
16. ICE Futures U.S., Inc.
17. Korea Exchange, Inc.
18. LIFFE Administration and Management
19. Montréal Exchange Inc.
20. Multi Commodity Exchange of India Limited
21. National Commodity & Derivatives Exchange Limited
22. NASDAQ OMX PHLX LLC
23. NASDAQ OMX Stockholm AB
24. New York Mercantile Exchange, Inc.
25. New Zealand Futures and Options Exchange Limited
26. NYSE Arca, Inc.
27. Osaka Securities Exchange Co., Ltd
28. Shanghai Futures Exchange
29. Singapore Exchange Derivatives Trading Limited

30. The London Metal Exchange Limited
31. Tokyo Financial Exchange Inc.
32. Tokyo Grain Exchange Inc.
33. Tokyo Stock Exchange, Inc.
34. Zhengzhou Commodity Exchange

SPECIFIED STOCK EXCHANGES

1. ASX Limited
2. BSE Limited
3. Borsa Italiana S.p.A.
4. Bursa Malaysia Securities Berhad
5. Deutsche Börse AG
6. Euronext Amsterdam N.V.
7. Euronext Brussels S.A./N.V.
8. Euronext Paris S.A.
9. Korea Exchange, Inc.
10. London Stock Exchange plc
11. Montréal Exchange Inc.
12. Nagoya Stock Exchange, Inc.
13. NASDAQ OMX Copenhagen A/S
14. NASDAQ OMX Helsinki Ltd
15. NASDAQ OMX Stockholm AB
16. National Stock Exchange of India Limited
17. New York Stock Exchange LLC
18. NYSE Amex LLC
19. NZX Limited
20. Osaka Securities Exchange Co., Ltd
21. Oslo Børs ASA
22. Singapore Exchange Securities Trading Limited
23. SIX Swiss Exchange AG
24. Sociedad Rectora de le Bolsa de Valores de Madrid, S.A. (Sociedad Unipersonal)
25. Société de la Bourse de Luxembourg S.A.
26. The NASDAQ Stock Market LLC
27. The Philippine Stock Exchange, Inc.
28. The Stock Exchange of Hong Kong Limited
29. The Stock Exchange of Thailand
30. Tokyo Stock Exchange, Inc.
31. TSX Inc.
32. Wiener Börse AG

Ascertainment of deemed assessable profits of a resident person holding indirect beneficial interest in a tax-exempt offshore fund



Note: \longrightarrow means direct beneficial interest
 \dashrightarrow means indirect beneficial interest

During the accounting year ended 31 March 2015, the tax-exempt offshore fund made profits of \$50 million from securities trading transactions in Hong Kong, which were exempt profits under the Exemption Provisions. The resident person held indirect beneficial interest of 50.4% (100% × 90% × 80% × 70%) in the offshore fund through interposed non-resident persons from 1 to 31 March 2015. The amount of the resident person's deemed assessable profits for the year of assessment 2014/15 ascertained in accordance with the formula in Schedule 15 is -

Amount of deemed assessable profits for a particular day in the year of assessment 2014/15 -

$$A = \frac{B \times C}{D} = \frac{50.4\% \times \$50\text{m}}{365 \text{ days}} = \$0.069\text{m}$$

Amount of the resident person's deemed assessable profits for the year of assessment 2014/15 (from 1 to 31 March 2015) -

$$= A \times 31 \text{ days} = \$0.069\text{m} \times 31 \text{ days}$$

$$= \underline{\underline{\$2.139\text{m}}}$$