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. 61

PROFITS TAX

PROFITS TAX EXEMPTION FOR 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.

WONG Kuen-fai
Commissioner of Inland Revenue

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INTRODUCTION

Public and private funds

In general, funds that are publicly offered in Hong Kong have to be authorized by and are subject to the applicable requirements of the Securities and Futures Commission (SFC), including requirements under the SFC's codes (i.e. SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products, SFC Code on MPF Products, Code on Real Estate Investment Trusts, Code on Pooled Retirement Funds and Code on Open-Ended Fund Companies (OFC Code)). However, there are no SFC authorization requirements on privately placed investment products offered to professional investors.

2. Funds that are privately offered (e.g. by way of private placements only) are not primarily subject to authorization from the SFC regarding offers of securities. However, a fund that is established in the form of an open-ended fund company (OFC), whether publicly or privately offered, will be subject to registration with and regulation by the SFC under the Securities and Futures (Open-ended Fund Companies) Rules (Cap. 571AQ) (OFC Rules) and the OFC Code.

3. Funds privately offered are not directly subject to specific legislation regarding their establishment and operation. However, persons who offer advice and services (i.e. regulated activity) to such funds or engaged in their marketing may be subject to licensing and regulation. In general, no requirements are prescribed for service providers or the qualifications of service providers of funds if the funds are not offered to the public.

Fund domiciliation

4. There are no local requirements that funds have to be formed or established in accordance with Hong Kong laws (i.e. Hong Kong domiciled funds).

5. Funds may be formed as a Hong Kong domiciled unit trust, limited partnership or OFC. Funds may also be domiciled in other jurisdictions by adopting legal vehicles available in the relevant jurisdictions (e.g. a Cayman exempted limited partnership).

Transfers of interests in funds

6. Transfers of interests in funds are not specifically regulated in Hong Kong. The transfers are normally subject to the specific provisions in the constitutive document and the process described therein. If the sale or transfer involves Hong Kong stock as defined in the Stamp Duty Ordinance, there will be stamp duty consequence unless exemption provisions therein apply.

Foreign Account Tax Compliance Act

7. Hong Kong and the United States (US) have signed Model II Intergovernmental Agreement (IGA) for Foreign Account Tax Compliance Act (FATCA) which establishes a framework of enabling Hong Kong financial institutions (HKSAR Financial Institutions) to seek consent for disclosure from US persons, and to report relevant tax information of such persons to the US Internal Revenue Service.

8. The IGA is supplemented by the operation of a tax information exchange agreement between Hong Kong and the US which provides for the exchange of information upon requests made in relation to the information reported by HKSAR Financial Institutions.

9. Unless specific exemption applies, privately offered funds, falling within the meaning of the term "investment entity" in the IGA, would have due diligence and reporting obligations under the IGA if they are HKSAR Financial Institutions:

(a) funds resident in Hong Kong (excluding branches located outside Hong Kong); and

(b) funds though not resident in Hong Kong have branches located in Hong Kong.

10. If an entity account holder is a passive NFFE[1] then a HKSAR Financial Institution must apply the prescribed review procedures to determine whether the account is held by a passive NFFE with one or more controlling

[1] The term "passive NFFE" is defined in Annex I of the IGA. The IGA is available at the website of the Financial Services and the Treasury Bureau (www.fstb.gov.hk/fsb/topical/doc/HK-USIGA.pdf).

persons who are US citizens or residents. In general, an NFFE is a passive NFFE if it functions (or holds itself out) as an investment fund, such as a private equity fund, venture capital fund, leveraged buyout fund, or any investment vehicle whose purpose is to acquire or fund companies and then hold interests in those companies as capital assets for investment purposes.

Common Reporting Standard

11. Hong Kong has also implemented by way of legislation the Common Reporting Standard (CRS) for the automatic exchange of financial account information in tax matters, mainly on a reciprocal basis, with CRS partners. Currently, Hong Kong would make use of different platforms for exchanging financial account information, including comprehensive avoidance of double taxation agreements and the Convention on Mutual Administrative Assistance in Tax Matters.

12. Funds, which are privately offered, falling within the meaning of the term "investment entity" in section 50A, would have due diligence and reporting obligations under Part 8A of the Inland Revenue Ordinance (IRO) if they are reporting financial institutions:

(a) funds resident in Hong Kong (excluding branches located outside Hong Kong); and

(b) funds though not resident in Hong Kong have branches located in Hong Kong.

13. If an entity account holder is a passive NFE then a reporting financial institution must "look-through" the entity to identify its controlling persons. If the controlling persons are reportable persons then information in relation to the financial account must be reported, including details of the account holder and each reportable controlling person. In general, an NFE[2] is a passive NFE if it functions (or holds itself out) as an investment fund, such as a private equity fund, venture capital fund, leveraged buyout fund, or any investment vehicle whose purpose is to acquire or fund companies and then hold interests in those companies as capital assets for investment purposes.

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[2] The term "passive NFE" is defined in section 50A(1) of the IRO.

Transfer pricing

14. The codification of the Organisation for Economic Co-operation and Development (OECD) transfer pricing rules in Part 8AA of the IRO empowers the Assessor to:

(a) adjust profits or losses where a transaction with a non-resident associated person is considered not arm's length and has created a potential advantage; and

(b) attribute an arm's length amount of profits to the permanent establishment in Hong Kong of a non-resident person if the profit reported is not the arm's length amount.

15. While the transfer pricing rules in Part 8AA apply to all enterprises, the following areas are of particular relevance to an investment manager:

(a) the management fee accrued to the investment manager in Hong Kong should commensurate with the investment manager's functional and risk profile within the overall asset management [3] value chain (i.e. the investment manager should be accrued an arm's length fee);

(b) the transfer pricing documentation, if any, should be sufficient to justify the transfer pricing of controlled transactions of the investment manager in Hong Kong and the attribution of profits to the permanent establishment in Hong Kong of a non-Hong Kong resident investment manager.

After the base erosion and profit shifting (BEPS) package of measures, endorsed by OECD and the Group of Twenty (G20), has become applicable, it is expected that profits will be reported where the economic activities that generate them are carried out and where value is created.

[3] Asset management in the present context means managing fund property on a discretionary basis. Though performing different functions with different risk profiles, investment managers and advisors are both subject to the transfer pricing rules in Part 8AA of the IRO.

TAX REGIMES RELATED TO FUNDS

Fund regime (on or after 1 April 2019)

16. The Council of the European Union had previously identified Hong Kong's tax regimes for offshore funds to be problematic on account of their ring-fencing features (i.e. profits tax exemption was provided to offshore, but not onshore, funds and the regimes only allowed offshore funds to have profits tax exemption with investment in private companies incorporated overseas but not locally).

17. The Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Ordinance 2019 (the 2019 Ordinance), which came into operation on 1 April 2019, sought to remove the ring-fencing features for funds while leaving intact other features under the existing tax regimes that are not related to funds per se. The 2019 Ordinance only provides profits tax exemption for privately offered funds operating in Hong Kong, whether domiciled inside or outside Hong Kong, since there are no tax disparity issue and ring-fencing concerns in relation to funds publicly offered.

18. The Department's interpretation and practice in relation to the provisions under the 2019 Ordinance, which are applicable to onshore and offshore funds, are set out in this Note. Details of the tax treatments before 1 April 2019 for offshore funds and offshore private equity funds can be found in Departmental Interpretation and Practice Notes (DIPN) No. 43 (Revised) (Profits Tax Exemption for Offshore Funds) and DIPN 51 (Profits Tax Exemption for Offshore Private Equity Funds). Unless specified otherwise, all the provisions quoted herein refer to the IRO.

Offshore fund regime (up to 31 March 2019)

19. Profits tax exemption for offshore funds was first introduced in 2006 by the Revenue (Profits Tax Exemption for Offshore Funds) Ordinance 2006 (the 2006 Ordinance). Under section 20AC, non-resident persons are exempted from profits tax in respect of profits derived from certain specified transactions carried out through or arranged by specified persons and transactions incidental to the carrying out of the specified transactions. To be eligible for tax exemption, the non-resident person must not carry on any other trade, profession

or business in Hong Kong involving any transaction other than specified and incidental transactions.

20. Non-resident persons in section 20AC include individuals, corporations, partnerships and trustees of trust estates. In determining whether a person is a resident, different legal tests are prescribed in section 20AB for individuals and non-individual entities respectively. The residence of an individual is based on the "ordinary or temporary residence" test while the residence of a corporation, partnership or trust estate is based on the "central management and control" test.

21. "Specified transactions" are broadly defined in Schedule 16 to cover typical transactions carried out by non-resident persons in Hong Kong. Schedule 16, when first added into the IRO, contained six categories of specified transactions: a transaction in securities; a transaction in futures contracts; a transaction in foreign exchange contracts; a transaction consisting in making a deposit other than by way of a money-lending business; a transaction in foreign currencies; and a transaction in exchange-traded commodities. "Specified persons" as defined in section 20AC(6) include corporations licensed and authorized financial institutions registered under the Securities and Futures Ordinance (Cap. 571) (SFO) for carrying on a business in any regulated activity as defined by Part 1 of Schedule 5 to the SFO. Deeming provisions prevent round-tripping or abuse by resident persons disguised as non-resident persons to take advantage of the exemption. If the beneficial interest of a resident person equals or exceeds the 30% threshold, the resident person will be deemed to have derived assessable profits in respect of profits derived by the non-resident person from specified transactions and incidental transactions in Hong Kong.

22. Section 20AC was enacted at the time when the provisions therein mainly applied to offshore hedge funds and did not address transactions typically carried out by private equity funds. Specifically, "specified transactions" in Part 1 of Schedule 16, which was first inserted into the IRO in 2006, did not include securities of a private company. In other words, offshore private equity funds that made use of the service of a "specified person" to derive profits from transactions in securities of private companies could be subject to profits tax. Besides, private equity funds might not necessarily be managed by corporations licensed or authorized financial institutions registered under the SFO.

Offshore private equity fund regime (up to 31 March 2019)

23. The Inland Revenue (Amendment) (No. 2) Ordinance 2015 (the 2015 Ordinance) was enacted to extend the profits tax exemption for offshore funds to cover offshore private equity funds from the year of assessment 2015/16 onwards. The 2015 Ordinance amended the definition of "securities" in Schedule 16 to the IRO so that a transaction in securities of a special purpose vehicle or an excepted private company is a "specified transaction". Section 20AC was also amended to provide for an additional avenue for bona fide private equity funds, which were not managed by persons licensed by or registered under the SFO, to be eligible for tax exemption. An offshore private equity fund carrying out a "specified transaction" would be eligible for tax exemption in respect of profits from that transaction if the specified transaction was carried out through or arranged by a specified person, or the offshore private equity fund conducting the specified transaction was a "qualifying fund".

Open-ended fund company regime (from 30 July 2018 to 31 March 2019)

24. Prior to the passage of the Inland Revenue (Amendment) (No. 2) Ordinance 2018 (the 2018 Ordinance) on 21 March 2018, publicly offered OFCs and OFCs with central management and control outside Hong Kong could enjoy profits tax exemption but privately offered OFCs with central management and control exercised in Hong Kong were still subject to profits tax. The 2018 Ordinance was enacted to put in place profits tax exemption arrangements for such privately offered OFCs. The 2018 Ordinance came into operation on 30 July 2018 in tandem with the implementation of OFC regime. The legal framework for OFCs, enacted under the Securities and Futures (Amendment) Ordinance 2016, is set out at Appendix 1.

25. Under section 20AH, now repealed, an OFC was exempted from payment of profits tax in respect of profits derived from:

(a) transactions in assets of a class specified in Schedule 16A, now repealed;

(b) transactions incidental to the carrying out of the transactions referred to in subparagraph (a) above; and

(c) transactions in assets of a class not specified in the repealed Schedule 16A.

The OFC, however, was not exempt from payment of tax in respect of profits from direct trading, direct business undertaking or utilization of assets in Hong Kong involving assets of a class not specified in the repealed Schedule 16A and transactions relating to certain types of private companies described in the repealed section 20AH(5) and (6).

26. Section 20AH, now repealed, required that the activities that produced assessable profits from the transactions of the OFC had to be carried out through or arranged in Hong Kong by a qualified person (i.e. corporations or authorized financial institutions licensed or registered under the SFO to carry out a business in Type 9 (asset management) regulated activity). This was in line with the investment manager requirement in section 112Z of the SFO. Further, to be eligible for tax exemption, the onshore privately offered OFC had to meet, among others, the "non-closely held" conditions set out in section 20AI and Schedule 16B, now repealed.

Co-investment partner funds under ITVF scheme

27. The Inland Revenue Ordinance (Amendment of Schedule 16) Notice 2018 (the Notice), which came into operation on 22 June 2018, added a specified transaction to Part 1 of Schedule 16 (i.e. a transaction in an investee company's shares carried out through or arranged by a specified person for, or carried out by, a non-resident partner fund). Relevant definitions were added to Part 2 of Schedule 16, including "investee company" and "non-resident partner fund".

28. The Notice sought to address the concern of offshore venture capital funds of losing their profits tax exemption status upon joining the Innovation and Technology Venture Fund (ITVF) Scheme. The ITVF set up by the Government is for the main purpose of attracting more private investment to the innovation and technology ecosystem in Hong Kong. The ITVF, through The Innovation and Technology Venture Fund Corporation (ITVFC), a special-purpose vehicle incorporated under the Companies Ordinance (Cap. 622), co-invests with venture capital funds selected as co-investment partners in the innovation and technology start-ups with adequate presence in Hong Kong. The Government via ITVFC is a passive investor, making direct investment in the "Eligible Local Innovation and Technology Start-ups" concurrently with the

co-investment partner funds upon invitation of the latter. Details of the ITVF Scheme and list of co-investment partners can be found at the website of ITVF administered by the Information and Technology Commission (www.itf.gov.hk).

FUND REGIME

Legal framework

29. The fund regime introduced by the 2019 Ordinance added in specific and self-contained provisions on the unified tax treatment for funds (i.e. sections 20AM to 20AY and Schedules 15C, 15D and 16C). With the operation of the 2019 Ordinance, all funds, regardless of their structure, their central management and control location, their size or the purpose that they serve, will enjoy profits tax exemption subject to meeting certain conditions.

30. The main provisions of the 2019 Ordinance are as follows:

(a) Section 20AM gives the meaning of "fund" for the purposes of sections 20AN to 20AY and Schedules 15C, 15D and 16C. The definition of "fund" replicates, with necessary modifications, that of "collective investment scheme" set out in section 1 of Part 1 of Schedule 1 to the SFO.

(b) Section 20AN exempts a fund, subject to meeting certain conditions, from payment of profits tax on its assessable profits arising from transactions in assets of a class specified in Schedule 16C, incidental transactions and (if the fund is an OFC) transactions in assets of a class not specified in Schedule 16C.

(c) Section 20AO exempts a special purpose entity (SPE) wholly or partially owned by a tax-exempted fund from the payment of profits tax on its assessable profits from transactions in certain securities in relation to an investee private company or an interposed SPE. If the fund is exempted under section 20AN, the SPE is also exempted to the extent that corresponds to the percentage of shares or interests that the fund holds in the entity.

(d) Sections 20AP and 20AQ deal with when an exemption under section 20AN or 20AO does not apply to a fund and a SPE. If the fund or the SPE (specified body) carries out transactions in shares, stocks, debentures, loan stocks, funds, bonds or notes (specified securities) of, or issued by, a private company, the following factors all contribute to the end result of whether an exemption under section 20AN or 20AO is to be available to the specified body:

(i) the company holding or not holding, whether directly or indirectly, immovable property;

(ii) the period of the company's specified securities being held by the specified body;

(iii) the specified body having or not having control over the company; and

(iv) the level of short-term assets held by the company.

(e) Section 20AR provides that sections 20AP and 20AQ do not apply to a partner fund that is a party to an agreement to which ITVFC is also a party.

(f) Section 20AS deals with when an exemption under section 20AN does not apply to an OFC.

(g) Section 20AT provides that if the instrument of incorporation of an OFC provides for the division of its scheme property (as defined by section 112A of the SFO) into separate parts, each of which is a sub-fund, then each sub-fund is to be regarded as an OFC for computing the assessable profits of the sub-fund.

(h) Sections 20AU and 20AV set out the circumstances under which the losses sustained by a fund or a SPE from certain transactions are available, or not available, for set off against its assessable profits.

(i) Section 20AW is an interpretation provision for sections 20AX and 20AY and Schedules 15C and 15D.

(j) Sections 20AX and 20AY set out the circumstances under which the assessable profits of a fund or a SPE are to be regarded as the assessable profits of a resident person if the resident person has a beneficial interest in the fund or SPE.

(k) Schedules 15C and 15D provide for how the amounts of assessable profits of resident persons are to be ascertained under sections 20AX and 20AY respectively.

(l) Schedule 16C sets out the classes of assets specified for the transactions for the purposes of section 20AN.

31. Since the unified tax treatment for funds applies to OFCs, sections 20AG to 20AL, Schedule 15B for ascertaining the amount of assessable profits of a resident person in an OFC, Schedule 16A concerning the classes of assets specified for the purposes of section 20AH, and Schedule 16B concerning the non-closely held requirement for OFC were repealed under the 2019 Ordinance.

Commencement Date

32. The 2019 Ordinance came into operation on 1 April 2019. It does not have any retrospective effect. A fund within the meaning of section 20AM, which meets the conditions in sections 20AN to 20AS, can enjoy the profits tax exemption from that day onwards.

33. On and after 1 April 2019, a reference in section 20AC to a "non-resident person" does not include a "fund" within the meaning of section 20AM. This interpretation applies only for any year of assessment commencing on or after 1 April 2019. In other words, on and after 1 April 2019, a "non-resident person" in section 20AC refers to a non-resident non-fund person or entity, including a non-resident individual and a non-resident business undertaking.

34. If an arrangement meets the definition of "fund" under section 20AM, it would be eligible for profits tax exemption under section 20AN for any year of assessment commencing on or after 1 April 2019. A non-resident person or entity which does not meet the definition of "fund" under section 20AM but can

satisfy the exemption conditions under section 20AC could continue to enjoy tax exemption thereunder.

Example 1

Fund-F, an investment scheme, was centrally managed and controlled in Jurisdiction-F. Fund-F closed its accounts on 31 December. Fund-F did not carry out any other business in Hong Kong other than carrying out the transaction in Hong Kong to acquire 1,000 shares of Company-HK listed on the Hong Kong Stock Exchange in January 2018. In January 2019, Fund-F sold 500 shares in Company-HK and made a profit. In May 2019, Fund-F sold the remaining 500 shares in Company-HK and also made a profit.

Fund-F was a non-resident entity before 1 April 2019. Since Fund-F did not carry on any other business in Hong Kong other than carrying out the transaction to sell 500 shares of Company-HK during the period from 1 January to 31 March 2019, Fund-F should be entitled to profits tax exemption provided under section 20AC in respect of the profits derived therefrom. If Fund-F satisfied the definition of "fund" in section 20AM on and after 1 April 2019, Fund-F should be entitled to profits tax exemption provided under section 20AN in respect of the profits derived from the sale of the remaining 500 shares in Company-HK in May 2019. Overall, Fund-F was exempted from payment of tax in respect of the profits derived from the sale of 1,000 shares in Company-HK during the basis period from 1 January to 31 December 2019 for the year of assessment 2019/20.

WHAT FUND MEANS

Meaning of fund

Encompassed concepts

35. The definition of "fund" in section 20AM replicates, with necessary modifications, that of "collective investment scheme" in section 1 of Part 1 of Schedule 1 to the SFO. The definition of "collective investment scheme" in the

SFO encompasses the concepts of "arrangement", "participating", "pooling" and "purpose". The conditions bring within the meaning of "fund" those arrangements that, broadly, have the characteristics of pooled investment. Section 20AM(2) provides that an arrangement in respect of any property is qualified as a fund if at all times during the basis period for the year of assessment all the following three conditions are satisfied:

(a) the arrangement must provide–

(i) for the property to be managed as a whole by, or on behalf of, the person operating the arrangement; or

(ii) for the contributions of the persons participating in the arrangement (participating persons) and the profits or income to be pooled; or

(iii) for both (i) and (ii); and

(b) the participating persons do not have day-to-day control over the management of the property even if they have the right to be consulted on, or to give directions in respect of, the management of the property; and

(c) the purpose or effect (or pretended purpose or effect) of the arrangement must be to enable the participating persons, whether by acquiring any right, interest, title or benefit in the property or any part of the property or otherwise, to participate in or receive–

(i) profits, income or other returns represented to arise (or to be likely to arise) from the acquisition, holding, management or disposal of the property (or any part of the property), or sums represented to be paid (or to be likely to be paid) out of any such profits, income or other returns; or

(ii) a payment or other returns arising from the acquisition, holding or disposal of, the exercise of any right in, the

redemption of, or the expiry of, any right, interest, title or benefit in the property or any part of the property.

Arrangement in respect of property

36. An "arrangement" is not defined in the IRO[4] and should be wide enough to cover different types of bona fide funds in operation, regardless of their structure, their central management and control location, their size or the purpose that they serve. Funds as arrangements can take different legal forms, including (but not limited to):

(a) a mutual corporation (e.g. a Hong Kong OFC, a United Kingdom open-ended investment company and a Belgian Société d'Investissement à Capital Variable);

(b) a limited partnership (e.g. a United Kingdom private fund limited partnership and a Delaware limited partnership);

(c) an arrangement under which property is held on trust for the participating persons by a trustee (e.g. a United Kingdom authorized unit trust and Australian managed investment trust); or

(d) an arrangement that creates rights in the nature of co-ownership where the arrangement takes effect by virtue of the law of a territory outside Hong Kong or legal arrangements in civil law jurisdictions (e.g. a United Kingdom Authorized Contractual Scheme, a Luxembourg Fonds Commun de Placement and an Irish Common Contractual Fund).

37. "Property" is widely defined in section 20AM(3) and includes:

(a) money, goods, choses in action and land (whether in Hong Kong or elsewhere); and

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[4] The term "arrangement" has a wide meaning. There can be arrangements though separate persons or separate companies, owned and controlled independently of each other, operate different aspects of the arrangements.

(b) obligations, easements and every description of estate, interest and profit, present or future, vested or contingent, arising out of or incidental to property mentioned in subparagraph (a).

Therefore, the term "property" covers all classes of assets (e.g. securities, equities and land) and includes assets held or located in or outside Hong Kong. The term can include amounts paid by participants to join the scheme; there is no requirement that those moneys be invested in some investment: *Financial Services Authority v Fradley and another* [2006] 2 BCLC 616 at 627.

Managed as a whole requirement

38. Section 20AM(2)(a)(i) requires that the property is managed as a whole by, or on behalf of, the person operating the arrangement. The term "person operating the arrangement" (i.e. the operator), not defined in the IRO, should refer to the person that has overall responsibility for management and performance of the functions of the fund, which may include investment advice and operational services[5]. The operator may have different responsibilities in different jurisdictions and may be subject to supervision by a number of different persons (e.g. trustees, custodians, depositories, external auditors, independent directors and compliance committees)[6].

39. The operator will often be responsible for ensuring that all the day-to-day activities of operating a fund are carried out competently. This may comprise a wide range of activities which include managing the investments in accordance with the objective of a fund, valuation, administration, accounting, promotion and distribution.

40. The operator when operating the arrangement may engage a "specified person" as defined in section 20AN(6) to carry out or arrange in Hong Kong transactions which may be qualifying or non-qualifying. In relation to a fund in trust form, the trustee is legally in charge of the trust estate and ultimately responsible to the beneficiaries (i.e. unit holders) and hence is considered to be the fund's operator. The trustee (if a specified person), as the operator, of a

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5 The meaning of the term "operator" used by International Organisation of Securities Commissions (IOSCO) is adopted in this DIPN. See IOSCO Public Document No. 40, Report on Investment Management - Principles for the Regulation of Collective Investment Schemes and Explanatory Memorandum, IOSCO Technical Committee, October 1994.

6 See IOSCO Public Document No. 69, Principles for the Supervision of Operators of Collective Investment Schemes, IOSCO Technical Committee, September 1997.

fund in trust form may directly carry out or arrange such transactions, or the trustee (if not a specified person) may engage a specified person to carry out or arrange such transactions.

41. In determining whether the operator's management managed the property "as a whole", consideration has to be given to the arrangement in fact operated, rather than requiring there to be an enforceable right of management. Whether that condition is satisfied requires an overall assessment and evaluation of the relevant facts. For that purpose, it is necessary to identify: what is "the property"; and what is the management thereof which is directed towards achieving the contemplated income or profit. It is not necessary that there should be no individual management activity, only that the nature of the arrangement is that, in essence, the property is managed as a whole, to which question the amount of individual management of the property would plainly be relevant: *Financial Conduct Authority v Capital Alternatives Ltd* [2014] 3 All ER 780.

Pooling requirement

42. Section 20AM(2)(a)(ii) requires the pooling of the capital contributions of the participating persons and the profits or income from which payment is made to them. The term "participating persons" is not defined and refers to the investors in a particular arrangement. In short, participating persons or participants are the beneficial owners of interests in the arrangements or the property underlying the arrangements whether they have legal ownership of their interests[7]. The participating persons of a fund in limited partnership form are the limited partners whereas the participating persons of a fund structured as an OFC are the shareholders.

43. The word "pool" is not defined and should be accorded its literal meaning[8]. Reading as a whole, the term "participating persons" used in section 20AM(2) refers to participants or investors of a pooled arrangement. The

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[7] The meaning of the term "participant" used by Her Majesty's Revenue and Customs (HMRC) is adopted. See HMRC Offshore Funds Manual OFM05100 Meaning of a Mutual Fund: Introduction – Section 356 TIOPA 2010.

[8] According to the Shorter Oxford English Dictionary (sixth edition), "pool" means "put (resources etc.) into a common stock or fund; share in common, combine for the common benefit". The mere fact that participants' moneys are held on trust for the participants according to their contributions does not prevent the moneys from being "pooled" if the moneys are aggregated or collectively managed rather than separately held and separately managed: *Financial Services Authority v Fradley and another* [2006] 2 BCLC 616 at 626.

capital contributions from multiple investors and their profits or income are combined together under an arrangement. Though section 20AM(2) refers to "participating persons", an arrangement under very special circumstances may be accepted or may continue to be accepted as a fund even if it has one investor at a certain point in time within a year of assessment (e.g. during the start-up period or winding-down period). However, it is apparent that an arrangement intended to have one single investor only is unlikely an arrangement under which the capital contributions and profits or income are pooled and would not satisfy the "pooling" requirement.

44. Though the contributions and profits or income are not pooled, the arrangement may still be a fund if the property is managed as a whole by or on behalf of the person operating the arrangement and other requirements as required in section 20AM(2) are satisfied. A broker would not generally be regarded as managing the share portfolios as a whole if the individual investors only engage the broker to carry out the administrative steps to buy or to sell shares for them according to the terms specified by each of them under specific instructions, and the arrangements are that individual investors would direct and make key profit-generating decisions in respect of their own share portfolios (e.g. when to sell and the selling price).

45. If the contributions and profits or income are pooled and the property is managed as a whole by or on behalf of the person operating the arrangement, the arrangement may also constitute a fund.

Separate pools of assets and different classes of interests

46. If an arrangement (e.g. umbrella fund or protected cell company) involves a number of "separate pools" of assets, then each asset pool will be considered separately for determining whether each pool should constitute a fund. Whether a particular arrangement with separate pools of assets is managed as a whole as required under section 20AM(2)(a)(i) or on an individual basis taking into account each investor's interests has to be decided in light of all the relevant facts and circumstances.

47. If an asset pool has different classes of interests (e.g. share classes carrying different rights), each class of interest will be considered separately for the purpose of determining whether that class of interest constitutes a separate

fund. However, the Commissioner is prepared to reduce the administrative burden placed on the operator by treating the different classes of interests as if they are a single fund provided that there is no segregation of assets and liabilities between classes of interests (e.g. the units of each different class issued in "series" are identical in all respects and the income of all share classes of the fund will derive from a single pool of assets in current and future reporting periods).

No day-to-day control

48. Section 20AM(2)(b) requires that the participating persons do not have day-to-day control over the management of the property. "Day-to-day control" [9] means routine, ordinary, everyday management or operational decisions. The phrase does not just mean the legal ability to decide what is to happen to the property. Rather, the test focuses on whether the participating persons can really make management decisions about the property. Where the contracts appear to give the participating persons "day-to-day control" but they do not have that control in practice, the arrangement may still be a fund even if the participating persons have the right to be consulted or give directions in respect of such management.

49. The term "participating persons" refers to investors in a particular arrangement and "control" would therefore mean having control by way of rights as an investor. If the fund manager, who is responsible for the overall operation of a fund[10], holds units or shares in the fund managed then that alone would not prevent the "no day-to-day control" requirement from being satisfied. In the case of a fund with an advisory committee, which would typically comprise either a few key investors or independent investment experts, nothing prevents the "no day-to-day control" requirement from being satisfied. Particularly so in this case as it would not be expected that the role of the fund manager would be usurped by such a committee. In case of a limited partnership, the limited partners as the participating persons do not have day-to-day control over the management of the property while the general partner who holds a minimal interest (e.g. 1%) in the limited partnership is responsible for the ultimate management, control and decision-making in respect of the property. Again

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9 The meaning of the term "day-to-day control" is explained in The Answers to Frequently Asked Questions regarding Part IV of the SFO on Offers of Investments, Appendix 1, Question 7, issued by the SFC.

10 Per Fund Manager Code of Conduct (FMCC) issued by the SFC, fund managers are responsible for the day-to-day operation and management of the fund and must comply with certain FMCC requirements.

this should not prevent the "no day-to-day control" requirement from being satisfied.

50. Merely having a right to be consulted or to give directions does not result in a participating person having day-to-day control (e.g. the right to a vote at annual general meetings, to participate in an advisory committee or to hold a veto right would not be considered to amount to day-to-day control).

51. In order for an arrangement to satisfy the "no day-to-day control" requirement, it is sufficient that any one of the individual participating persons is not a party to exercising day-to-day control, regardless of the extent of their interest in the fund. In other words, all investors must have day-to-day control over the management of their properties for an arrangement not to be a fund. Even if one investor does not have day-to-day control, the arrangement could still be a fund.

Purpose or effect of the arrangement

52. Section 20AM(2)(c) requires that the purpose or effect of the arrangement is to enable the participating person to participate in the acquisition, holding, management or disposal of the property, or to receive profits or income from those transactions or sums paid out of such profits or income. The requirement is deliberately drawn widely so that it applies to a broad range of arrangements that are designed to facilitate pooled investments. The purpose or effect of a fund is to enable the participation or receipt by participating persons of profits, income, or returns via the arrangement. Such purpose or effect of a fund is a question of fact which depends on the objective evidence.

At all times requirement

53. An arrangement will only qualify as a fund if it meets all the requirements listed in section 20AM(2)(a), (b) and (c) at all times during the basis period for the year of assessment. The "at all times" requirement is to ensure that an arrangement qualifies as a "fund" continuously throughout the year of assessment so long as it claims for profits tax exemption for that year. For a fund which is newly set up during a year of assessment, its fund status will be determined by reference to the period from its set-up date to the end of the basis period for the year of assessment. Likewise, for a fund which is being

wound up during a year of assessment, its fund status will be determined by reference to the period from the beginning of the basis period for the year of assessment to the date of cessation of business.

54. A fund may change its status during a year of assessment (i.e. from a non-fund entity to a fund entity or vice versa). If a non-fund entity in the first half of a year of assessment becomes eligible as a fund in the second half of the year of assessment, the entity will not be allowed profits tax exemption because it fails to meet the "at all times" requirement in section 20AM(2). Profits tax exemption can only be considered for the year of assessment following the year of assessment in which its status changed.

Complex and multi-vehicle fund structures

55. Complex and multi-vehicle fund structures, including master-feeder structures and parallel funds, may be used in order to accommodate the preferences of fund investors. The totality of facts, including the constitutive documents, the investment mandate and the management agreements, would be examined to decide whether the feeder funds or parallel funds constitute in law and in fact one or more than one fund within the meaning of "fund" in section 20AM(2).

Example 2

Fund(LP)-F, being the principal fund, was a private equity fund in the form of a limited partnership resident in Jurisdiction-F with two parallel funds at all times during the year of assessment 2019/20. The fund agreement of each parallel fund was substantially the same as the fund agreement for the principal fund, subject to modifications for regulatory, tax, structuring or other reasons. The size of the principal fund and the parallel funds were aggregated for the purposes of any overall fund size cap, and investors in the principal fund and the parallel funds generally were aggregated for the purposes of voting under the fund agreements.

The totality of facts, including the constitutive documents, the investment mandate and the management agreements, would be examined to decide whether the two parallel funds constituted two

different funds within the meaning of "fund" in section 20AM(2). If the two parallel funds constituted two different and separate funds, each parallel fund would be regarded as a "fund" for profits tax purposes. In the example, Fund(LP)-F, the principal fund, and two parallel funds should be looked upon as a single fund.

Example 3

Hedge Fund-F1 was resident in Jurisdiction-F1 with a master-feeder structure at all times during the year of assessment 2019/20. In this case, the sponsor formed two feeder funds that would aggregate the commitments of certain investors from Jurisdiction-F2 and Jurisdiction-F3. One feeder fund was structured as a blocker vehicle and was taxed as a corporation for income tax purposes in Jurisdiction-F2. Another feeder fund was structured as a transparent vehicle and the investors were taxed directly for income tax purposes in Jurisdiction-F3. These feeder funds would then invest directly in Hedge Fund-F1.

Feeder funds are often vehicles to account for the needs of the investors and they may not have independent existence on their own. To determine whether the feeder funds constitute in law and in fact one or more than one fund within the meaning of "fund" in section 20AM, the totality of facts including the constitutive documents would be examined. Since the two feeder funds were set up purely to address the needs of investors from different jurisdictions for investment into Hedge Fund-F1 only, the two feeder funds would not constitute as two separate funds within the meaning of "fund" in section 20AM. It would not be inappropriate to regard Hedge Fund-F1 and two feeder funds as one single fund for the purposes of section 20AM(2).

Example 4

National Pension Plan-F of Jurisdiction-F funded retirement pensions, disability pension, death benefits, survivor's pension and other pension/benefit for some 18 million contributors and beneficiaries in Jurisdiction-F. National Pension Plan-F, as a limited partner,

invested in Fund(LP)-HK in the form of a limited partnership at all times during the year of assessment 2019/20. Fund(LP)-HK was a private equity fund, centrally managed and controlled in Hong Kong.

In general, a pension fund of such a scale is regulated by legislation and is likely to operate with great independence. The participants and beneficiaries of the pension fund would have no direct or indirect control or influence over the management of investments made by the pension fund. For the purposes of determining whether Fund(LP)-HK is a qualifying investment fund, National Pension Plan-F would be counted as one investor.

Sovereign wealth fund

56. Sovereign wealth funds are pools of assets owned and managed directly or indirectly by governments under an arrangement to achieve national objectives. Their objectives usually include:

(a) to diversify assets;

(b) to get a better return on reserves;

(c) to provide for pensions in the future;

(d) to provide for future generations when natural resources run out;

(e) to insulate the budget and the economy against commodity (usually oil) price swings;

(f) to promote industrialisation; and

(g) to promote strategic and political objectives.

57. Since a sovereign wealth fund may not fit in the definition of "fund" under section 20AM(2), section 20AM(4) expressly provides that a sovereign wealth fund is to be regarded as a fund under section 20AM(2). A sovereign wealth fund is defined in section 20AM(4) to mean an arrangement established

and funded by a state or government (or any political subdivision or local authority of a state or government) for the purposes of:

(a) carrying out financial activities; and

(b) holding and managing a pool of assets,

for the benefit of the state or government (or the political subdivision or local authority).

Excluded arrangements

58. Even if an arrangement does fall within the meaning of a fund in section 20AM(2), it is further necessary to determine whether or not it is an excluded arrangement. Section 20AM(5) excludes from the definition of "fund" the following arrangements:

(a) *Arrangement not operated by way of business*

If an arrangement is operated otherwise than by way of business (i.e. non-business arrangement), the arrangement will fall outside the scope of fund. If an arrangement is managed as a business by a person, the arrangement will be regarded as falling within the scope of fund whether or not the person is conducting any business.

(b) *Group scheme*

Each of the participating persons of an arrangement is a corporation in the same group of companies as the operator of the arrangement. It refers to an arrangement or structure within a corporate group and does not relate to situations where a fund which begins in a year of assessment with a single seed investment by an affiliate of the investment manager.

(c) *Employee share scheme*

Each of the participating persons of an arrangement is–

(i) a bona fide employee or former employee of a corporation in the same group of companies as the operator of the arrangement; or

(ii) a spouse, widow, widower, minor child (natural or adopted) or minor step-child of such employee or former employee.

The effect of this exclusion is clear: taxable remuneration/ benefits of employees (e.g. share option scheme, share award scheme, profit-sharing plan, post-employment benefit arrangement and termination benefit arrangement) will be prevented from being turned into tax exempted distributions through a tax exempted fund structure[11]. A private pension fund operated by a group of companies would fall within this exclusion.

(d) *Franchise arrangement*

An arrangement is a franchise arrangement if under which the franchisor or franchisee earns profits or income by exploiting a right conferred by the arrangement to use a trade name or design or other intellectual property or goodwill attached to it.

(e) *Solicitor's accounts*

An arrangement under which money is taken by a solicitor (whether from the solicitor's client or as a stakeholder) acting in the solicitor's professional capacity in the ordinary course of the practice.

[11] Under the IRO, a pension fund, other than a mandatory provident fund scheme or occupational retirement scheme, is chargeable to profits tax and contributions by an employer to such a pension fund are not tax deductible.

(f) *Compensation fund*

The arrangement is made for the purposes of a fund or a scheme maintained by –

(i) the SFC within the meaning of the SFO; or

(ii) a recognized exchange company, a recognized clearing house, a recognized exchange controller or a recognized investor compensation company, within the meaning of the SFO,

under the SFO for providing compensation in the event of default by an exchange participant, or a clearing participant, within the meaning of the SFO.

(g) *Credit union fund*

An arrangement made by a credit union registered under the Credit Unions Ordinance (Cap. 119) in accordance with the objects of the credit union.

(h) *Chit-fund*

The arrangement is made for the purposes of any chit-fund permitted to operate under the Chit-Fund Businesses (Prohibition) Ordinance (Cap. 262).

(i) *Publicly offered fund*

The arrangement is a mutual fund, unit trust or similar investment scheme falling within the descriptions in section 26A(1A)(a)(i) and (ii). Such an arrangement is exempted from profits tax under section 26A(1A) and is excluded so as to avoid overlapping of the exemption provisions.

Business undertaking for commercial or industrial purposes

59. Since the policy objective is to provide profits tax exemption to a fund operating in Hong Kong, the fund as an investment vehicle is not expected and allowed to engage in activities undertaken by companies or entities for general commercial or industrial purposes. To reduce the risk of tax abuses by businesses repackaging themselves as funds, section 20AM(6) makes it clear that a business undertaking for general commercial or industrial purposes is not a fund. A business undertaking would include any commercial or industrial activity without limiting to those activities listed in section 20AM(7). Specifically, a fund is not permitted under section 20AM(7) to engage in the following activities (which are not exhaustive):

(a) a commercial activity that involves–

(i) any purchase, sale or exchange of goods or commodities; or

(ii) any supply of services;

(b) an industrial activity that involves any production of goods or construction of immovable property as defined by section 20AP(4);

(c) property development or property holding (other than self-used property);

(d) finance, including–

(i) banking;

(ii) providing capital (other than providing capital to a SPE, or an investee private company, as defined in section 20AO(4));

(iii) leasing;

(iv) factoring;

(v) securitization; and

(vi) money-lending;

(e) insurance business;

(f) construction or direct acquisition of infrastructure as defined in section 20AP(4);

(g) making direct investments that derive rent, royalties or lease payments.

60. The term "immovable property" as defined by section 20AP(4) means land (whether covered by water or not), any estate, right, interest or easement in or over any land, and things attached to land or permanently fastened to anything attached to land, but does not include infrastructure.

61. The term "infrastructure" as defined by section 20AP(4) means any publicly or privately owned facility providing or distributing services for the benefit of the public, and includes any water, sewage, energy, fuel, transportation or communication facility.

62. For the sake of clarity, a fund's engagement in "qualifying transactions" specified in Schedule 16C will not be regarded as a business undertaking for general commercial or industrial purposes.

63. In relation to property development or property holding, the following activities would be covered:

(a) direct investment in an immovable property to derive rent;

(b) provision of services incidental to the earning of rent from direct investment in an immovable property (e.g. parking fees, utilities and common security services provided in the letting property to lessees);

(c) licenses and other rights to use an immovable property (e.g. serviced apartment);

(d) direct sale of goods or supply of services or provisions of facilities in relation to an immovable property;

(e) sale or disposal of an immovable property (or of a long-term lease of an immovable property) that has been acquired for development, re-sale or disposal;

(f) direct investment in an infrastructure which derives infrastructure income (e.g. tolls, transmission charges, availability payments).

64. A fund investing in a private company which engages in one of the activities specifically listed in section 20AM(7), would be regarded as having "indirectly" engaged in those activities and such indirect activities would not prevent the fund from being eligible for profits tax exemption under section 20AN.

65. An arrangement will only qualify as a fund if it meets all the requirements set out in section 20AM(2)(a), (b) and (c) at all times during the basis period for the year of assessment. The "at all times" requirement equally applies to the "no business undertaking" condition. In other words, a fund is not permitted to directly engage in any trading or business activities for general commercial or industrial purposes at any time during the year of assessment.

66. If an arrangement directly engages in a commercial activity that involves the purchase and sale of goods (e.g. purchase and sale of garments) in the first half of the year of assessment and engages in qualifying transactions specified in Schedule 16C in the second half of the year of assessment, the arrangement would not be a fund. Equally, an arrangement would not be regarded as a fund if part of its investment for the year of assessment is property holding other than self-used property (e.g. an office). As a rule, it would not be necessary to look beyond the fund in determining whether the "no business undertaking" condition is satisfied (i.e. commercial or business undertaking carried on by an investee private company or an investor would not be taken into account for determining whether the fund is engaged in any commercial or business undertaking). In relation to a fund in trust form, since the trustee is legally in charge of the trust estate and holds the legal title of the trust's properties, any commercial or business undertaking carried on by the trustee of the trust

estate for the fund would be regarded as commercial or business undertaking carried on by the fund.

67. If an arrangement is directly engaged in both commercial and investment activities, it would not qualify for profits tax exemption under section 20AN even though it satisfies the requirements in section 20AM(2). Strictly, an arrangement which engages directly in a business undertaking for general commercial or industrial purposes would not meet the definition of "fund" under section 20AM. In determining whether the fund is a business undertaking for general commercial or industrial purposes as prohibited under section 20AM(6) and (7), a fund's activities in and outside Hong Kong would be considered as a whole.

Example 5

Company-HK, incorporated in Hong Kong in 2006, all along has been carrying on commercial and investment business activities in Hong Kong. Company-HK closed its accounts on 31 December annually. On 1 April 2019, Fund-HK was set up as a fund with Company-HK and four other investors. From 1 April 2019 to 31 December 2019, Fund-HK used funds contributed by Company-HK and the other four investors to carry out Schedule 16C transactions.

In order to qualify for profits tax exemption under section 20AN, Fund-HK had to first satisfy the meaning of "fund" under section 20AM(2). Second, Fund-HK should not fall within the exclusions in section 20AM(5). Third, Fund-HK should not be a business undertaking for general commercial or industrial purposes which carried out commercial or industrial transactions as prohibited under section 20AM(6) and (7). The totality of facts would be examined in determining whether Fund-HK was a qualifying investment fund operating in Hong Kong.

THE EXEMPTION PROVISIONS

Exemption from tax payment

68. The exemption provisions are contained in section 20AN. Subject to sections 20AP and 20AQ, a fund is exempt from payment of tax in respect of its assessable profits for a year of assessment if:

(a) the profits are earned from–

(i) transactions in assets of a class specified in Schedule 16C (qualifying transactions);

(ii) transactions incidental to the carrying out of qualifying transactions (incidental transactions); and

(iii) transactions in assets of a class that is not specified in Schedule 16C (non-Schedule 16C class) if the fund is an OFC; and

(b) at all times during the basis period for a year of assessment either–

(i) the qualifying transactions are carried out in Hong Kong by or through, or arranged in Hong Kong by a specified person (i.e. a corporation licensed or an authorized financial institutions registered under the SFO to carry on a business in any regulated activity as defined under the SFO); or

(ii) the fund is a qualified investment fund.

Scope of exemption

69. An arrangement which meets the definition of "fund" in section 20AM and fulfils the exemption conditions specified in section 20AN would be eligible for profits tax exemption in respect of its qualifying transactions. The exemption also covers profits derived from the incidental transactions provided that the

fund's trading receipts from the incidental transactions do not exceed 5% of the total of the fund's trading receipts from both the qualifying transactions and the incidental transactions.

70. A fund can carry on any trade, profession or business in Hong Kong, involving transactions other than the qualifying transactions and transactions incidental to the carrying out of the qualifying transactions. The tax-exempted profits of the fund from qualifying transactions and incidental transactions will not be tainted even if the fund is taxed on its profits derived from transactions in assets of non-Schedule 16C class (non-qualifying transactions). If the profits or gains derived from non-qualifying transactions are offshore or capital in nature, they remain not chargeable to profits tax. It should be noted that an arrangement must first satisfy the definition of "fund" under section 20AM in order to qualify for profits tax exemption. If an arrangement is in substance a business undertaking for general commercial or industrial purposes, it is not a fund and its profits derived in a year of assessment from qualifying and non-qualifying transactions can be charged to profits tax. If the arrangement is not a fund in the first place, the provisions for profits tax exemption in section 20AN would not be applicable to the arrangement.

71. An OFC incorporated under Part IVA of the SFO is an open-ended collective investment scheme and is subject to the regulatory requirements of the SFC. Publicly offered OFCs are allowed to invest in asset classes in accordance with the SFC's product code requirements and authorization conditions (i.e. mainly in securities and futures). Privately offered OFCs are allowed to invest mainly in asset types the management of which would constitute a Type 9 regulated activity in accordance with the investment scope laid down in the OFC Code and other asset classes not exceeding 10% gross asset value of the OFC (10% de minimis rule). Since an OFC is regulated by the SFC and in particular, a privately offered OFC is required to comply with the 10% de minimis rule as per the OFC Code, profits tax exemption is given to the OFC in respect of profits derived from transactions in permissible asset classes which include qualifying and non-qualifying transactions. Despite section 20AN, the OFC will be taxed on its profits from carrying on a direct trading or direct business undertaking in Hong Kong in assets of a class not specified in Schedule 16C or holding of assets of a non-Schedule 16C class that are utilized to generate income. Thus, the tax-exempt profits of the OFC will not be tainted. If an OFC breaches the OFC Rules and/or OFC Code (including the 10% de minimis rule) in a way that results

in cancellation of registration by the SFC, the OFC will not qualify for profits tax exemption under section 20AN.

Classes of assets for qualifying transactions

72. Schedule 16C to the IRO contains the list of 11 classes of assets specified for qualifying transactions. It covers typical transactions carried out by funds:

(a) securities;

(b) shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a private company;

(c) futures contracts;

(d) foreign exchange contracts under which the parties to the contracts agree to exchange different currencies on a particular date;

(e) deposits other than those made by way of a money-lending business;

(f) deposits (as defined by section 2(1) of the Banking Ordinance (Cap. 155)) made with a bank (as defined by Part 1 of Schedule 1 to the SFO);

(g) certificates of deposit (as defined by Part 1 of Schedule 1 to the SFO);

(h) exchange-traded commodities;

(i) foreign currencies;

(j) OTC derivative products (as defined by Part 1 of Schedule 1 to the SFO); and

(k) an investee company's shares co-invested by a partner fund and ITVFC under the ITVF Scheme.

73. Part 1 of Schedule 16C covers the specified transactions in Schedule 16 and classes of assets specified in Schedule 16A which has been repealed. The definitions in Part 2 of Schedule 16C are based on those in Schedule 16 with the necessary modifications. The important definitions of the classes of assets specified for qualifying transactions and their interpretations are at Appendix 2.

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

Incidental transactions

75. A fund may carry out transactions in Hong Kong which are not qualifying transactions but incidental to the carrying out of the qualifying transactions. The term "incidental transaction" is not defined. The word "incidental", which is accorded its common meaning[12], should cover various modes of operation of different funds. Whether particular transactions carried out by a fund are "incidental transactions" is a question of fact, the answer to which can only be determined by reference to the particular mode of operation of the fund concerned. Typical incidental transactions include custody of securities, and receipt of interest or dividend on securities acquired through the qualifying transactions.

76. The incidental transactions carried out in the relevant year of assessment are subject to the 5% threshold and tax exemption is to be allowed in respect of the profits derived therefrom. Section 20AN(4) provides that the exemption under section 20AN(2) does not apply to assessable profits earned from incidental transactions if the percentage calculated according to the following formula exceeds 5%:

$$A/B \times 100\%$$

where–

A = the fund's trading receipts from incidental transactions in the basis period;

[12] 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".

B = the total of the fund's trading receipts from qualifying transactions and incidental transactions in the basis period.

77. The 5% threshold refers to the situation where the fund's trading receipts from the incidental transactions do not exceed 5% of the total trading receipts from the qualifying transactions and the incidental transactions taken together. If the 5% threshold is exceeded, the whole of the fund's 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 qualifying transactions, however, will remain fully exempt from tax. Incidental transactions should have been chargeable profits and the policy intent of the 5% threshold is to provide operational convenience only.

78. The holding of a debt instrument (e.g. debentures, loan stocks, bonds or notes) to earn "interest income" is not a transaction in securities since such holding does not involve two parties transacting in securities. The payment of "interest" therefrom is not a "transaction in securities" since the payment of interest to holders of the debt instrument merely gives effect to the rights already attached to the debt instrument. The receipt of interest could only be considered as an incidental transaction subject to the 5% threshold and not a "qualifying transaction". Generally, the buying and selling of a debt security is a qualifying transaction falling within section 20AN(2)(a) while the payment and receipt of interest from such a debt security is an incidental transaction falling within section 20AN(2)(b).

79. In calculating the percentage according to the formula stipulated in section 20AN(4), exempted or non-taxable sums, such as dividends, capital receipts or offshore income are excluded from the fund's trading receipts.

Specified persons

80. Tax exemption is allowed in respect of profits derived by a fund from qualifying transactions if the qualifying transactions of the fund are:

(a) carried out in Hong Kong by or through a specified person; or

(b) arranged in Hong Kong by a specified person.

81. The specified person is defined in section 20AN(6) to mean 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 SFO. The words "arranged in Hong Kong by" cover cases where a qualifying transaction is not carried out by a specified person but arranged in Hong Kong by the specified person to be carried out by another person (e.g. the investment manager of a fund, who is a specified person, can arrange in Hong Kong to buy or sell stocks traded on the Tokyo Stock Exchange through an intermediary in Tokyo). In relation to an OFC, the investment manager, who is licensed by or registered with the SFC to carry out a Type 9 regulated activity and qualified as a specified person, may sub-delegate the investment management function to an overseas sub-manager or advisor with or without discretionary power to buy or sell.

Qualified investment fund

Definition of qualified investment fund

82. Tax exemption is also allowed in respect of profits derived by a fund from qualifying transactions if the fund is a qualifying investment fund. The definition of "qualified investment fund" in section 20AN(6) has followed the definition of "qualifying fund" in section 20AC(6) with slight modifications. In order to be a qualified investment fund, the following conditions must be met:

(a) at all times after the final closing of sale of interests–

(i) the number of investors exceeds 4; and

(ii) the capital commitments made by investors exceed 90% of the aggregate capital commitments; and

(b) an agreement governing the operation of the fund provides that not more than 30% of the net proceeds arising out of the transactions of the fund are to be received by the originator and the originator's associates, after deducting the portion attributable to their capital contributions (which is proportionate to that attributable to the investors' capital contributions).

83. Section 20AN(6) contains definitions of "aggregate capital commitment", "associate", "capital commitment", "final closing of sale of interests", "investor", "net proceeds" and "originator" in relation to the meaning of "qualified investment fund". These definitions have followed the meaning of the same terms in section 20AC(6).

84. For the purposes of a qualified investment fund, the "investor" is defined to mean a person, other than the originator or the originator's associates, who makes capital commitment to the fund. The "originator" means a person who directly or indirectly originates or sponsors the fund and has the power to make investment decisions on behalf of the fund. In the context of a limited partnership structure, generally the "investors" are the limited partners and the "originator" is the general partner.

85. The term of "capital commitment" means a commitment that is in the form of an amount of money payable by an investor, the originator or the originator's associate to the fund under an agreement governing the operation of the fund and in respect of which the originator may make capital calls from time to time according to the terms of the agreement. The "aggregate capital commitment" is the total of the capital commitments made by the investors, the originator and the originator's associates.

86. In relation to a qualified investment fund, "final closing of sale of interests" is defined to mean the date on which the originator last accepts subscriptions from investors for making capital commitments. The time of "final closing" should be clear from the fund document or prospectus which forms part of a contract agreed at the outset. In relation to private equity funds which are generally closed ended vehicles, the Commissioner would not accept that an originator can continually vary the closing date by inviting new subscribers into the fund, thereby moving the reference point of time.

87. Provisions on "associate" are required to prevent the fund from being controlled by the originator and its associates. Section 20AN(6) contains the definition of "associate" and the related definitions of "associated corporation", "associated partnership", "control", "principal officer" and "relative".

Number of investors

88. The requirement of having at least five investors, who have made capital commitments in the fund, at any time after the final closing of sale of interests is not new and has already been adopted for "qualifying fund" in section 20AC(6). In a multi-layer ownership structure with a series of intermediaries or a fund of funds structure, it is essential to correctly identify the fund for the purposes of section 20AN(2) before counting the number of investors. To determine whether it is appropriate to see through a series of intermediaries or a fund of funds structure (e.g. feeder funds or parallel funds) when counting the number of investors, the totality of facts, including the constitutive documents, the investment mandate and the management agreements, would be examined to decide whether the intermediaries, feeder funds or parallel funds constitute different and separate funds for the purposes of sections 20AM and 20AN.

89. An investor like a pension fund, an insurance company or a sovereign wealth fund would be counted as one single investor for the purposes of counting the number of investors and determining whether a fund is a qualified investment fund, even though they have a large number of participating persons and beneficiaries.

Capital commitment

90. The 90% capital commitment requirement in defining a qualified investment fund is the same as that for "qualifying fund" in section 20AC(6). The purpose of this requirement is to ensure that the fund is not simply a vehicle of one single investor. The term "capital commitment" is defined in section 20AN(6) to mean a commitment in respect of which the originator may make calls from time to time for payment of the capital, which has not been paid or satisfied by an investor, the originator or the originator's associate according to the terms of an agreement governing the operation of the fund. The term "capital calls" in the definition of "capital commitment" is not defined in the IRO. It carries the literal meaning (i.e. calls or requests for capital) and such calls are invariably governed by the contractual terms laid down in an agreement governing the operation of the fund.

30% of net proceeds

91. The requirement of having "not more than 30% of net proceeds" is the same as that for "qualifying fund" in section 20AC(6). The reference to the 30% threshold is intended primarily to deny tax exemption to funds the profits of which are simply siphoned to one single investor who may be the fund manager. The requirement also ensures that the vehicle is a bona fide fund (i.e. the fund is not simply a vehicle primarily owned by the fund manager with other investors holding a nominal interest).

92. It is not uncommon in the private equity business to reward the investment manager a performance fee or carried interest which is around 20% of the fund's profits above a hurdle rate. The 30% threshold is higher than the industry benchmark of 20%. In considering whether the 30% threshold has been observed, it is necessary to refer to various documents, such as the limited partnership agreement, so as to ascertain the performance fee, performance linked reward, carried interest or profit-related return (however described). It is also expected that fund constitutive documents, such as private placement memorandum and management agreement, would be made available to the Commissioner to prove that the fund is established as a bona fide private equity fund.

93. Section 20AN(6) defines the term "net proceeds", in relation to a qualified investment fund at a particular time, to mean an amount calculated by:

(a) adding together–

(i) the sum of the cumulative distributions received by the investors, the originator and the originator's associates from the fund by the particular time; and

(ii) the value at the particular time of all assets, if any, held by the fund; and

(b) subtracting the cumulative capital contributions of the investors, the originator and the originator's associates by the particular time.

94. Distributions are always made by the operator after making provisions for all known liabilities as required by the distribution provisions in the agreement governing the operation of the fund. Therefore, it is expected that the "distributions" in the definition of "net proceeds" have been arrived in such manner.

EXEMPTION FOR SPECIAL PURPOSE ENTITIES

Exempt from tax payment

95. The scope of exemption for SPEs under the fund regime is the same as that for special purpose vehicles under the offshore private equity regime. The aim is to cater for a case where a fund sets up one tier or multiple tiers of SPEs to hold their investment in private companies so as to facilitate the subsequent disposal of such companies by way of transferring the ownership interests in SPEs.

96. With the definition of "securities" in section 1 of Part 2 of Schedule 16C and subject to sections 20AP and 20AQ, funds are exempt from payment of tax in respect of profits derived from a transaction in:

(a) shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by a SPE;

(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 of a SPE; or

(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 of a SPE.

97. Section 20AO has replicated the exemption provisions for special purpose vehicles contained in section 20ACA. Subject to sections 20AP and 20AQ, a SPE is exempted, to the extent corresponding to the percentage of the tax-exempted fund's ownership of the SPE, from payment of tax in respect of its

assessable profits arising from the following transactions:

(a) transactions in shares, stocks, debentures, loan stocks, funds, bonds or notes (specified securities) of, or issued by, an investee private company or an interposed SPE;

(b) transactions in rights, options or interests (whether described as units or otherwise) in, or in respect of, the specified securities; and

(c) transactions in certificates of interest or participation in, temporary or interim certificates for, receipts for, or warrants to subscribe for or purchase, the specified securities.

Meaning of SPE

Restrictions

98. The definition of "SPE" in section 20AO(4) is the same as the definition of "special purpose vehicle" in section 20ACA(2). A SPE means a corporation, partnership, trustee of a trust estate or any other entity that:

(a) is wholly or partially owned by a fund;

(b) is established solely for the purpose of holding, whether directly or indirectly, and administering one or more investee private companies;

(c) is incorporated, registered or appointed in or outside Hong Kong;

(d) does not carry on any trade or activities except for the purpose of holding, whether directly or indirectly, and administering one or more investee private companies; and

(e) is not itself a fund or an investee private company.

Legal forms

99. A SPE is a purpose-built structuring tool of funds. It may be a corporation, partnership, trustee of a trust estate or any other entity which is incorporated, registered or appointed in or outside Hong Kong. It can be wholly or partially owned by a fund and is established solely for the purpose of holding, directly or indirectly, and administering one or more investee private companies. The term "any other entity" is included in the definition of "SPE" so as to facilitate the use of various forms of SPE by the industry.

Permitted activities

100. A SPE, as defined in section 20AO(4), is not allowed to carry on any trade or activities other than for the purpose of holding, directly or indirectly, and administering one or more investee private companies. It should not engage in an active business with buying and selling transactions (i.e. trading transactions). Equally, it cannot derive service fees from a fund for the provision of services. The SPE is expected to only derive passive dividend income from one or more investee private companies.

101. Since the words "holding" and "administering" are not defined, they should be interpreted according to their literal meaning (i.e. holding and administering investee private companies in the capacity as a shareholder or a holder of participation or equity interest). The "holding" and "administering" of an investee private company can be direct or through other persons. It should not be interpreted as the management of the business of the investee private companies (i.e. maintenance and administration of the business of investee private companies would not be allowed). Hence, the activities of a SPE are restricted to:

(a) the review of financial statements of investee private companies normally made available to shareholders or investors;

(b) attending the shareholders' meetings of investee private companies;

(c) opening bank accounts for collection of dividends or investment receipts; and

(d) appointing company secretary and auditor.

If the obligations undertaken by a SPE far exceed those normally attached to a shareholder, the SPE would not satisfy the exemption requirement.

102. The SPE in this context is not meant to be an investee private company. In practice, the investee private company can be identified after examining the transactions and having regard to the fund documents, including the investment mandate of the fund.

Interposed SPE

103. The term "interposed SPE" is defined in section 20AO(4) to have the same meaning of "interposed special purpose vehicle" in section 20ACA(2) as follows:

(a) in relation to a SPE that has an indirect beneficial interest in an investee private company through an interposed person that is a SPE, means the interposed person; or

(b) in relation to a SPE that has an indirect beneficial interest in an investee private company through a series of 2 or more interposed persons that are SPEs, means any of the interposed persons.

104. The definition of "interposed SPE" has made it clear that an interposed SPE is also a SPE. The "SPE" and "interposed SPE" will only be exempt from profits tax to the extent corresponding to the percentage of ownership interests held by the fund which is exempt from profits tax under section 20AN(2) in the year of assessment. A SPE indirectly owned by a fund is an "interposed SPE".

SPE as holding platform

105. The provisions in section 20AO will remain applicable to a holding platform entity if the holding platform entity used by a fund as a regional investment platform is a SPE. In other words, the holding platform entity is:

(a) established solely for the purpose of holding and administering investee private companies;

(b) the activities of the holding platform entity are restricted to activities for the purpose in subparagraph (a) above.

The holding of assets, other than interests in investee private companies, is not within the scope of activities permitted under the definition of SPE in section 20AO(4). Indeed, the assets held by the holding platform entity have to be investee private companies as defined in section 20AO(4).

Example 6

Limited Partnership-F1, resident in Jurisdiction-F1, was a fund as defined in section 20AM. Holding Platform Entity-HK, a private company resident in Hong Kong, was wholly-owned by Limited Partnership-F1.

Holding Platform Entity-HK was operated as a regional investment platform through which an investment return was generated for Limited Partnership-F1 from investee private companies located in Asia-Pacific region including Hong Kong.

Investment Manager-HK, a specified person, was engaged to provide services in Hong Kong to Limited Partnership-F1, including: monitoring the performance of the investee private companies; making of investment decisions; offering advice on growth of the portfolio; contracting to buy and sell the investee private companies.

Holding Platform Entity-HK held:

(a) 100% of the share capital in Company-HK in Hong Kong, through Company(SPE)-HK1;
(b) 100% of the share capital in Company-F2 in Jurisdiction-F2 through Company(SPE)-HK2;
(c) 100% of the share capital in Company-F3 in Jurisdiction-F3 through Company(SPE)-HK3;

Company-HK, Company-F2 and Company-F3 were investee private companies carrying on business in Hong Kong, Jurisdiction-F2 and Jurisdiction-F3 respectively.

Company(SPE)-HK1, Company(SPE)-HK2 and Company(SPE)-HK3 were interposed SPEs incorporated in Hong Kong and established solely for the purposes of holding and administering Company-HK, Company-F2 and Company-F3.

Tax treatment of Limited Partnership-F1, Holding Platform Entity-HK, Investment Manager-HK, Company(SPE)-HK1, Company(SPE)-HK2 and Company(SPE)-HK3 would be as follows:

Limited Partnership-F1

Limited Partnership-F1 would be exempt from payment of tax as a fund if the conditions under sections 20AN, 20AP and 20AQ were satisfied.

Holding Platform Entity-HK

Holding Platform Entity-HK operated as a regional investment platform. Since it was structured in the form a SPE, Holding Platform Entity-HK would be exempt from payment of tax as a SPE under section 20AO(2) if the conditions under sections 20AN, 20AP and 20AQ were satisfied.

Investment Manager-HK

Since Investment Manager-HK was providing investment management service to Limited Partnership-F1, it would be assessed to profits tax in accordance with the principles in section 14.

Company(SPE)-HK1, Company(SPE)-HK2 and Company(SPE)-HK3

Company(SPE)-HK1, Company(SPE)-HK2 and Company(SPE)-HK3 would be exempt from payment of tax as interposed SPEs under section 20AO(2) if the conditions under sections 20AN, 20AP and 20AQ were satisfied.

Investee private company

106. In section 20AO(4), the term "investee private company" is defined to mean a private company held by a SPE or an interposed SPE as a shareholder on behalf of the fund.

107. The term "private company" in relation to the definition of "investee private company" has the same meaning given by section 20ACA(2). That means a company, whether incorporated in or outside Hong Kong, that is not allowed to issue any invitations to the public to subscribe for any shares or debentures of the company. In deciding whether a company is not allowed to issue invitations to the public to subscribe for its shares or debentures, all circumstances will be examined. If the company is incorporated in Hong Kong, the relevant provisions in the Companies Ordinance will be applied to determine whether the company is a private company (i.e. whether it can issue invitations to the public for capital). If the company is incorporated outside Hong Kong, provisions in overseas legislation, including but not limiting to overseas company legislation, will be applied to determine whether the company is allowed to issue invitations to the public for capital. If taking additional steps or seeking approval would allow the company to issue invitations to the public but without involving a substantial change to its nature, the company is treated as not prohibited from issuing shares or debentures to the public. In general, neither a listed company nor a non-private unlisted company (i.e. a public company with more than 50 members) would be treated as a "private company".

108. An investee private company is a private company in corporate form by definition. Accordingly, the exemption for SPE in section 20AO applies to specified securities of an investee private company in corporate form only and not those of a non-corporate entity (e.g. partnership or trust).

Example 7

Fund-F1 was a private equity fund resident in Jurisdiction-F1. It held 100% of the share capital in Company-F2 in Jurisdiction-F2, through Company(SPE)-HK1 and Company(SPE)-HK2, which were both Hong Kong incorporated companies without any trade or business activities in Hong Kong other than the holding of the share capital in Company-F2. Company(SPE)-HK1 held Company(SPE)-HK2, which in turn held Company-F2.

Company(SPE)-HK1 was a SPE and Company(SPE)-HK2 was an interposed SPE. Company(SPE)-HK1, Company(SPE)-HK2 and Company-F2 were the "special purpose entity", "interposed special purpose entity" and "investee private company" respectively as defined in section 20AO(4). Fund-F1 would be exempt from tax

under section 20AN(2) on profits derived from disposal of shares in Company(SPE)-HK1 (i.e. a SPE). Company(SPE)-HK1 would be exempt from payment of tax under section 20AO(2) on profits derived from disposal of shares in Company(SPE)-HK2 (i.e. an interposed SPE). Company(SPE)-HK2 would be exempt from payment of tax under section 20AO(2) on profits derived from sale of shares in Company-F2 (i.e. an investee private company).

Example 8

Fund-HK was a private equity fund resident in Hong Kong. It wholly owned Company-SPE which in turn formed a joint venture with another investor to make investment in Company-F in Jurisdiction-F.

Company-SPE and Company-F fell respectively within the definitions of "special purpose entity" and "investee private company" as defined in section 20AO(4). Fund-HK would be exempt from tax under section 20AN(2) on profits derived from disposal of shares in Company-SPE (i.e. a SPE). Company-SPE would be exempt from payment of tax under section 20AO(2) on profits derived from disposal of shares in Company-F (i.e. an investee private company).

Example 9

Fund-HK, resident in Hong Kong, fell within the definition of "fund" in section 20AM. Fund-F1, resident in Jurisdiction-F1, was a fund which did not meet the definition of "fund" in section 20AM. Fund-HK and Fund-F1 respectively owned 70% and 30% shares in Company-SPE which in turn made investment in Company-F2 in Jurisdiction-F2. Company-F2 did not carry on any business in Hong Kong.

Company-SPE fell within the definition of "special purpose entity" in section 20AO(4). Fund-HK would be exempt from tax under section 20AN(2) on profits derived from disposal of shares in Company-SPE (i.e. a SPE) if the conditions in section 20AP or 20AQ are met. Fund-F1 would not be exempt from tax under section 20AN(2) on profits derived from disposal of shares in Company-SPE (i.e. a SPE) because

Fund-F1 failed to meet the definition of "fund" under section 20AM. However, Fund-F1 could receive exemption under section 20AC(2) as a non-resident non-fund entity.

Company-SPE would be exempt from payment of tax under section 20AO(2) and (3) in respect of its 70% profits from the sale of shares in Company-F2 (i.e. an investee private company). Company-SPE would also be exempt from payment of tax under section 20ACA(1) in respect of its 30% profits from the sale of shares in Company-F2 (i.e. an excepted private company as defined in section 20ACA(2)).

Example 10

Fund-HK, resident in Hong Kong, was a fund falling within the definition of "fund" in section 20AM. It invested in the shares issued by Investee Private Company-HK and Investee Private Company-F2, incorporated in Hong Kong and Jurisdiction-F2 respectively, through Company(SPE)-F1, which was incorporated and resident in Jurisdiction-F1, without any trade or business activities in Hong Kong other than the holding of Fund-HK's investments.

Company(SPE)-F1, Investee Private Company-HK and Investee Private Company-F2 fell respectively within the meanings of "special purpose entity" and "investee private company" in section 20AO(4). Since Fund-HK was exempted from profits tax under section 20AN, Company(SPE)-F1 would also be exempt from profits tax under section 20AO(2) in respect of its profits from the sale of the two investee private companies' shares if the conditions in section 20AP or 20AQ were met. In deciding whether exemptions should be given to Fund-HK and Company(SPE)-F1, the fact that the investee private companies were or were not carrying on business in Hong Kong (except the holding of immovable property in Hong Kong) would not be of any relevance.

INVESTMENT IN PRIVATE COMPANIES

Transaction in shares of private company

109. Private companies may hold any type of assets in Hong Kong. In order to reduce the risk of tax evasion by funds through their investment in private companies, sections 20AP and 20AQ specify the circumstances under which the profits tax exemption in sections 20AN and 20AO would not apply to transactions carried out by a fund or a SPE in securities of, or issued by, a private company. The term "private company" has the meaning given by section 20AO(4). If a fund or a SPE (specified body) carries out transactions in shares, stocks, debentures, loan stocks, funds, bonds or notes (specified securities) of, or issued by, a private company (relevant company), the following factors will all contribute to the end result of whether profits tax exemption under section 20AN or 20AO is to be available to the specified body:

(a) the relevant company holding or not holding, whether directly or indirectly, immovable property (immovable property test);

(b) the period of the relevant company's specified securities being held by the specified body (holding period test);

(c) the specified body having or not having control over the relevant company (control test); and

(d) the level of short-term assets held by the relevant company (short-term asset test).

The diagram at Appendix 3 shows how the above tests would operate in practice. Sections 20AP and 20AQ deal with investment in specified securities of a private company only and not those of a non-corporate entity such as partnership or trust.

Immovable property test

110. The relevant company held by the specified body is not expected to invest excessively in Hong Kong immovable property market. The immovable property test aims to prevent the relevant company from converting taxable

profits derived from property investment into non-taxable income via a fund structure. It is stipulated that the aggregate value of the immovable property held in Hong Kong by the relevant company and the share capital (however described) in another private company, with direct or indirect holding of immovable property in Hong Kong, cannot exceed 10% of the value of the relevant company's assets. This 10% threshold in the immovable property test is not new and has been adopted for "excepted private company" in section 20ACA(2).

111. If the 10% threshold in the immovable property test is exceeded, the specified body is not exempt from the payment of profits tax in respect of the profits arising from transactions in specified securities. If the 10% threshold in the immovable property test is not exceeded, the specified body will be exempt from tax if the holding period test, the control test and short-term asset test are satisfied in good faith by the specified body.

112. In case the relevant company does not hold, whether directly or indirectly, immovable property in Hong Kong nor share capital (however described) in another company holding immovable property in Hong Kong, the specified body will be exempt from tax if it satisfies the holding period test, the control test and short-term asset test in good faith. The words "in good faith" are intended to guard against notional but not genuine compliance of the requirement. Similar wording (i.e. the Latin equivalent "bona fide") can be found in the IRO, such as section 26A(1A)(a)(ii) (relating to profits tax exemption for publicly offered funds) and section 14G(1) (relating to profits tax concessions to qualifying aircraft lessors and qualifying aircraft leasing managers).

113. The term "immovable property" is widely defined in section 20AP(4) to mean: land (whether covered by water or not); any estate, right, interest or easement in or over any land; and things attached to land or permanently fastened to anything attached to land, but does not include infrastructure. In this context, the term "infrastructure" means any publicly or privately owned facility providing or distributing services for the benefit of the public, and includes any water, sewage, energy, fuel, transportation or communication facility.

114. The term "share capital (however described)" covers all forms of participation interests or equity interests which entitle the holders to participate

in or share profits accrued to the relevant company, with or without a share capital.

115. The "value of its assets" refers to the "market value" of the relevant company's assets. In calculating the value of the total assets of the relevant company, debts of the company including liabilities secured by mortgages on the relevant immovable property are not deducted. Thus the values used in the percentage calculation are in gross amount.

116. When applying the 10% threshold, it is necessary to examine the audited financial statements of the relevant company for the latest year, supplemented by management accounts up to the date of transaction in securities, to determine:

(a) the market value of the holding of immovable property in Hong Kong;

(b) the market value of the holding of share capital in another private company with direct or indirect holding of immovable property in Hong Kong; and

(c) the market value of the assets of the relevant company.

117. Due to price fluctuation, the value of immovable properties held by the relevant company may exceed 10% of its assets at one time and fall below 10% at another time during the year of assessment. If a fund invests in the relevant company with immovable property assets, there is concern at which point in time the immovable property test would be applied to determine the fund's eligibility for tax exemption under section 20AN and whether the fund needs to keep track of the value of the immovable properties held by the relevant company. Generally, it may not be necessary to obtain a valuation of the underlying immovable properties since the fund might not be able to request a valuation of the immovable properties. A snapshot at the time of transaction of the relevant company's assets would be taken. The eligibility for tax exemption would then be assessed according to the proportion of the immovable properties' value over the relevant company's assets.

Holding period test

118. The holding period test is targeted at encouraging funds to focus on the long-term prospects of the investee private companies. The two-year period under the holding period test is drawn up having regard to the genuine operational needs of private equity funds.

119. If the relevant company does not hold, whether directly or indirectly, any immovable property in Hong Kong, or holds, whether directly or indirectly, not more than 10% of its assets in immovable property in Hong Kong and the investment in the relevant company has been held by the specified body for at least two years (whether or not the specified body has control over the relevant company), the specified body will not be taxed on the profits arising from the transaction in securities in the relevant company. If the relevant company has been held by the specified body for less than two years, the control test and the short-term asset test will apply.

120. In section 20AP(3) and section 20AQ(3), the term "transaction" refers to the disposal of securities of the relevant company whereas the expression "series of transactions" will be interpreted in line with section 50AAI of the IRO. The two-year period counts from the date when the specified body acquired the specified securities of the relevant company.

Control test and short-term asset test

121. The control test and the short-term asset test are to reduce the risk of tax abuse by engaging in trading activities (i.e. transacting in trading assets) through sales of specified securities in private companies.

122. If the two-year holding period test cannot be satisfied, profits tax exemption would only be provided under the following conditions:

(a) the specified body does not have a controlling stake in the relevant company; or

(b) the specified body has a controlling stake in the relevant company, but the relevant company does not hold more than 50% of the value of the relevant company's assets in short-term assets.

123. The word "control" is defined in section 20AN(6) and means, in relation to a corporation, the power of a person to secure: by means of the holding of shares or the possession of voting power in or in relation to the corporation or any other corporation; or by virtue of any powers conferred by the articles of association or other document regulating the corporation or any other corporation, that the affairs of the corporation are conducted in accordance with the wishes of the person. A controlling interest in a private company normally refers to over 50% ownership interest. In relation to a partnership, "control" means, the power of a person to secure: by means of the holding of interests or the possession of voting power in or in relation to the partnership or any other partnership; or by virtue of any powers conferred by the partnership agreement or other document regulating the partnership or any other partnership, that the affairs of the corporation are conducted in accordance with the wishes of the person.

124. In relation to the specified securities of the relevant company, "short-term asset" is defined in section 20AP(4) to mean an asset:

(a) that is of a class not specified in Schedule 16C;

(b) that is not immovable property in Hong Kong; and

(c) that has been held by the company for less than 3 consecutive years before the date of disposal of the specified securities.

125. In this context, a short-term asset is not limited to the asset held in Hong Kong. The "3 consecutive years before the date of disposal" requirement counts backward from the date when the specified securities of the relevant company are being disposed of by a fund, whether or not through a SPE.

Example 11

Fund-HK, resident in Hong Kong, was a fund falling within the definition of "fund" in section 20AM. On 1 April 2019, Fund-HK acquired 51% of the shares in Private Company-HK, which was incorporated and carrying on business in Hong Kong without holding any immovable properties in Hong Kong. The value of short-term assets of Private Company-HK did not exceed 50% of the value of

Private Company-HK's assets. On 1 June 2019, Fund-HK disposed 2% of the shares in Private Company-HK. On 2 July 2019, Fund-HK further disposed 49% of the shares in Private Company-HK.

Fund-HK was exempt from payment of tax in respect of its assessable profits derived from transactions in the shares of Private Company-HK because the value of Private Company-HK's short-term assets did not exceed 50% of the value of Private Company-HK's assets though Fund-HK disposed of the shares in Private Company-HK less than two years after acquisition and had control over Private Company-HK.

Example 12

Fund-HK, resident in Hong Kong, was a fund falling within the definition of "fund" in section 20AM. On 1 January 2018, Fund-HK acquired all the shares in Private Company-F2 in Jurisdiction-F2 through Company(SPE)-F1 which was incorporated in Jurisdiction-F1. Private Company-F2 carried on a retailing business in Jurisdiction-F2 and it closed its accounts on 31 December every year. At all relevant times, Private Company-F2 was held by Company(SPE)-F1. On 1 May 2019, Fund-HK sold all the shares in Company(SPE)-F1 and made a profit. Private Company-F2's unaudited statement of financial position gave the following details:

As at	***Value of Short-term Assets of Private Company-F2***	***Value of Total Assets of Private Company-F2***
30.4.2019	*$1,000m*	*$1,500m*

It might not be practicable to require the submission of Private Company-F2's audited statement of profit or loss for the period from 1 January 2019 to 30 April 2019 and Private Company-F2's audited statement of financial position as at 30 April 2019. Private Company-F2's unaudited financial statements, certified by the directors of Private Company-F2, might be used by the Assessor for computing the following percentage:

As at	Value of Short-term Assets of Private Company-F2 divided by Value of Total Assets of Private Company-F2
30.4.2019	$1,000m ÷ $1,500m = 66.67%

Fund-HK was not exempt from payment of tax in respect of its assessable profits derived from the transaction in the shares of Company(SPE)-F1 for the following reasons:

(a) Fund-HK disposed of the shares in Company(SPE)-F1 less than two years after acquisition of such shares;

(b) Fund-HK through Company(SPE)-F1 held 100% shares in Private Company-F2 and had control over Private Company-F2; and

(c) Private Company-F2's short-term assets value exceeded 50% of the value of Private Company-F2's assets.

Listed/ unlisted securities

126. Depending on the market conditions, a fund may sell its investment in an investee private company to another strategic investor or to the public through an initial public offering (IPO). If the fund sells its investment in the investee private company through an IPO, it is in substance no different from a transaction in listed securities or a transaction in securities of an investee private company. That is, the fund will continue to be eligible for profits tax exemption in respect of the divestment if the exemption conditions in section 20AN remain satisfied. Conversely, if a listed company after privatisation is sold as an investee private company, the fund will continue to be exempt from profits tax provided the same exemption conditions have been fulfilled. The extent of exemption for a SPE is the percentage of the tax-exempted fund's ownership of the SPE in the year of assessment. It is recognized that a SPE may be required to hold certain percentage of the securities of an investee private company for a reasonable period of time after IPO. If the SPE does not commence to carry on any trade or activities other than the holding of investments in investee private companies, including listed securities converted from the SPE's previous interests in investee private company after IPO, the Commissioner would continue to accept that the SPE remains a SPE.

ITVF SCHEME

127. Profits tax exemption for investment co-invested in private companies by the ITVFC and the partner funds remains the status quo. Given that the co-investment is subject to the control and monitoring of the Information and Technology Commission (including that the investee companies have to meet the criteria for "Eligible Local Innovation and Technology Start-up" of the ITVF Scheme), section 20AR specifies that the co-investment transactions do not need to be subject to the tests in sections 20AP and 20AQ (i.e. immovable property test, holding period test, control test and short-term asset test). Yet, investment in private companies by the partner funds on their own (i.e. not co-investment with the ITVFC) will be subject to the four tests. The IRO does not prevent the use of a SPE in a co-investment by a partner fund of the ITVF Scheme. However, a transaction in shares of a SPE held by a partner fund is not a transaction in assets of Class 11 specified in Schedule 16C.

OPEN-ENDED FUND COMPANY

Tax treatments for non-qualifying transactions

128. Section 20AS, replicated from the provisions in the repealed section 20AH(7), provides for the disapplication of profits tax exemption to an OFC. Despite that an OFC may enjoy profits tax exemption on transactions in assets of a non-Schedule 16C class pursuant to section 20AN(2)(c), if an OFC meeting the definition of "fund" in section 20AM[13] engages in direct trading or direct business undertaking in Hong Kong in assets of a non-Schedule 16C class, or utilizes assets of a non-Schedule 16C class to generate income, it will be assessed to profits tax in respect of its assessable profits earned from the trading, business undertaking or utilization. Since the mode of operation of each OFC differs, it would be difficult to specify in the IRO the types of non-qualifying transactions carried out by OFCs, and how the assets of a non-Schedule 16C class would be used for direct trading or direct business undertaking. Transactions in assets of a non-Schedule 16C class of an OFC and incidental transactions would not

[13] A publicly offered or privately offered OFC is not allowed to be a business undertaking for general commercial or industrial purposes. See Chapter 7 of the SFC Handbook for Unit Trusts and Mutual Funds and Chapter 11 of the OFC Code. Therefore, an OFC would generally be accepted as a fund under section 20AM for the purposes of tax exemption.

qualify for profits tax exemption if such transactions relate to assets which are normally purchased and sold in the normal course of business of a commercial or industrial enterprise, in particular those mentioned in section 20AM(7), and the OFC constitutes as a business undertaking for general commercial or industrial purposes. In any event, an OFC would not be assessed to profits tax in respect of any offshore profits or capital gains, whether relating to assets of a class specified in Schedule 16C or not.

Sub-funds of OFC

129. An OFC may be created as an umbrella fund meaning that the OFC could consist of a number of separately pooled sub-funds and each sub-fund would have a pool of assets that is managed in accordance with the investment objectives and policies for that particular sub-fund. Operationally, each sub-fund would also be distinct. Per section 20AT, replicated from the provisions in the repealed section 20AG, if the instrument of incorporation of an OFC (i.e. the main company) provides for the division of its scheme property (as defined by section 112A of the SFO) into separate parts (each of which is a sub-fund), then when applying section 14 to the main company:

(a) a reference to assessable profits in section 14 is a reference to the total of the assessable profits of all of its sub-funds; and

(b) for computing the assessable profits of the sub-funds–

(i) each sub-fund is to be regarded as an OFC;

(ii) the main company is to be regarded as not being an OFC; and

(iii) the provisions of Part 4 of the IRO apply to a sub-fund as if it were an OFC.

130. Tax exemption should be allowed to each sub-fund separately as long as each sub-fund meets the exemption conditions as set out in section 20AN. If the condition for exemption from payment of tax under section 20AN is met in respect of a sub-fund, the sub-fund is exempt from tax under that section even if the condition is not met in respect of another sub-fund of the main company.

As a matter of symmetry, any loss sustained by a sub-fund is not available for set off against any assessable profits of another sub-fund of the main company.

131. Since a sub-fund is not a legal person, section 20AT(3) provides that a main company will be liable for the profits tax attributable to each of its sub-funds. The tax liability of the main company is the aggregate amount of tax liability on each sub-fund's profits. Having regard to the segregated liability of sub-funds as mentioned in section 112S of the SFO, any profits tax liability attributable to a sub-fund must only be discharged out of the assets of the sub-fund. In other words, the assets of a sub-fund must not be used to discharge the liabilities under the IRO of the main company or any other sub-fund, and any liability incurred on behalf of a sub-fund may only be discharged out of its assets.

132. The main company being a legal person has to bear the legal obligation of complying with the provisions of the IRO on reporting chargeability, lodgement of returns, providing information, lodgement of objections and appeals, payment of tax, etc. Penalties and offences under Part 14 of the IRO would be imposed on the main company for failures to comply with the relevant statutory provisions. In case any liabilities (e.g. penalties for late filing of returns) are not attributable to any particular sub-fund, the main company may allocate any liabilities between its sub-funds in a manner that it considers as fair to its shareholders according to section 112S(5) of the SFO.

LOSS TREATMENTS

Losses sustained by funds (other than OFC) and SPE

133. The loss treatment under section 20AU is the same as that set out in section 20AD. As a rule, losses sustained by a fund other than an OFC in respect of its qualifying transactions and incidental transactions are not available for set off against any of its assessable profits for the year of assessment or any subsequent year of assessment. Likewise, losses sustained by a SPE from qualifying transactions and incidental transactions in specified securities and the related rights, options or interests in an investee private company or an interposed SPE in a year of assessment are not available for set off against any of its assessable profits for the year of assessment or any subsequent year of assessment.

Losses sustained by OFC

134. The loss treatment under section 20AV is the same as that set out in the repealed section 20AL(1) and (3). As a rule, losses sustained by an OFC from qualifying transactions, incidental transactions or transactions in assets of a non-Schedule 16C class per section 20AN(2)(a), (b) and (c) in a year of assessment are not available for set off against any of its assessable profits for the year of assessment or any subsequent year of assessment. In addition, losses sustained by an OFC from a specified activity, profits of which are not tax-exempted, in a year of assessment are only available for set off against any of its assessable profits earned from the specified activity for the year of assessment or any subsequent year of assessment. Specified activity in this context means a transaction, a direct trading, a direct business undertaking or utilization of assets in a non-Schedule 16C class.

ANTI-ROUND TRIPPING PROVISIONS

Resident person with not less than 30% interest

135. The anti-round tripping provisions under sections 20AX and 20AY, same as those set out in sections 20AE and 20AF, are to prevent abuse or round-tripping by resident persons to take advantage of the profits tax exemption. Section 20AY also prevents booking of profits in SPEs without distributing to the fund.

136. If a resident person, either alone or jointly with the person's associates, holds a beneficial interest (whether direct or indirect or both) of not less than 30% in a fund with profits exempted under section 20AN, or any percentage if the fund is the resident person's associate, the resident person is deemed under section 20AX to have derived assessable profits in respect of the profits earned by the fund from the qualifying transactions and incidental transactions carried out in Hong Kong. Where the fund has a beneficial interest (whether direct or indirect or both) in a SPE that is exempt from the payment of tax in respect of its assessable profits from transactions falling within section 20AO, the resident person is deemed under section 20AY to have derived assessable profits in respect of the profits earned by the SPE.

137. The provisions in sections 20AX and 20AY apply in any year of assessment commencing on or after 1 April 2019.

Resident person / non-resident person

Definition of residence

138. Section 20AW sets out the definitions of "resident person" and "non-resident person" for the purposes of sections 20AX and 20AY and Schedules 15C and 15D. In determining the residency for sections 20AX and 20AY, different legal tests are prescribed for individuals and non-individual entities which include corporations, partnerships and trustees of trust estates. By definition, a non-resident person is a person who is not a resident person.

Individuals

139. In relation to a year of assessment, an individual is regarded as a resident person if the individual ordinarily resides in Hong Kong in that year of assessment, or 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 IRO relating to the concepts "ordinarily resident" and "temporary resident" which qualify an individual for election for personal assessment.

140. For the purpose of determining an individual's residency, it is generally considered that an individual "ordinarily resides" in Hong Kong if the individual has a permanent home in Hong Kong where the individual or the individual's family lives. The mere fact that an individual holds a Hong Kong identity card is inconclusive in showing that the individual ordinarily resides in Hong Kong. In this respect, the Board of Review in its decision *D57/02*, IRBRD vol 17, 829 applied the test adopted by the Court of Appeal in *Director of Immigration v Ng Shun-loi* to decide 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)."

141. In ascertaining the number of days an individual 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

142. 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.

Central management and control

143. The "central management and control" test is a well-established common law rule adopted in many jurisdictions, such as the UK, Australia and Singapore, 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."

144. 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.

145. 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 meet in the jurisdiction where the business operations take place, and central management and control is clearly located in that jurisdiction. 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. 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.

146. 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 (e.g. the board chairman, the managing director or general partner), the relevant locality is the place where the controlling individual exercises the individual's 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.

Beneficial interest

Definition of beneficial interest

147. Section 20AW sets out the definitions of "direct beneficial interest" and "indirect beneficial interest" for the purposes of sections 20AX and 20AY and Schedules 15C and 15D.

Direct beneficial interest

148. Section 20AW(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) the person holds any of the issued share capital (however described) of the corporation (where the corporation is not a trustee of a trust estate);

(b) the person, 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);

(c) the person, 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 (i.e. capital) or income; or

(d) the person has any of the ownership interests in the entity which is not a corporation, a partnership and a trustee of a trust estate.

149. Section 20AW(8) provides that if a partner 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 20AW(8) as a reference to the entitlement to a distribution of the partnership's assets upon its dissolution.

150. Section 20AW(9) provides that the reference to the issued share capital of a corporation does not include the shares comprised in the issued share capital of the corporation that do not entitle the 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. Thus, when computing the percentage of the issued share capital of the corporation held by a fund manager, non-profit participating shares held by the fund manager for the sole purpose of managing a fund corporation are excluded.

Example 13

Mutual Fund Corp-F, resident in Jurisdiction-F, had issued 10,000 shares, out of which 500 were "management shares" and holders were entitled to special management rights but not dividends or distributions of assets upon dissolution. Fund Management Corp-HK, a fund management company resident in Hong Kong, was appointed as the fund manager of Mutual Fund Corp-F. Fund Management Corp-HK was allotted the 500 management shares and it further acquired 1,500 shares issued by Mutual Fund Corp-F.

The extent of Fund Management Corp-HK's direct beneficial interest in Mutual Fund Corp-F was computed as 1,500 ÷ (10,000 – 500) = 15.79%. The 500 management shares were excluded in ascertaining Fund Management Corp-HK's beneficial interest in Mutual Fund Corp-F.

Indirect beneficial interest

151. Section 20AW(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 (the other person) if, through a third person (interposed person) or through a series of two or more interposed persons, who is or are related to the person and the other person in the way described in section 20AW(6) and (7):

(a) the person 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) the person is entitled to any of the profits of the partnership (where the partnership is not a trustee of a trust estate);

(c) the 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; or

(d) the person has any of the ownership interests in the entity which is not a corporation, a partnership and a trustee of a trust estate.

152. Section 20AW(6) provides that if there is one interposed person, the person has a direct beneficial interest in the interposed person and the interposed person has a direct beneficial interest in the other person. Section 20AW(7) further provides that if there is a series of two or more interposed persons, the person has a direct beneficial interest in the first interposed person in the series; each interposed person (other than the last interposed person) in the series has a direct beneficial interest in the next interposed person in the series; and the last interposed person in the series has a direct beneficial interest in the other person.

Control of a trust estate

153. A person who has the control of the activities of a trust estate can distribute the trust estate's income or asset according to the person's discretion and to whomever the person chooses including himself. To counteract opportunities for tax-avoidance, a resident person who has a direct or indirect beneficial interest in a trustee of a trust estate by reason of the fact that the resident person 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, is to be regarded as being interested in 100% in value of the trust estate per sections 20AX(5) and 20AY(4).

Associate

154. In administering the anti-round tripping provisions under sections 20AX and 20AY, provisions on "associate" are required to prevent resident persons from circumventing these provisions by holding beneficial interests in funds through associates. Under section 20AX(2), beneficial interests in a fund held by a resident person's associates, resident or non-resident, will be taken into account in determining whether the "not less than 30%" threshold is exceeded. Besides, in the case where a resident person holds a beneficial interest in a fund which is the resident person's associate, the anti-round tripping provisions will apply, per sections 20AX(3) and 20AY(2), in respect of any percentage of the resident person's beneficial interest in the fund.

155. 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 the person's "relative", the person's partner and a corporation controlled by the person. 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 is the resident corporation. In respect of a resident person which is a partnership, "associate" generally includes a partner in and a corporation controlled by the resident partnership. The definition of "associate" in section 20AN(6) covers 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.

156. 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 is the resident partnership.

157. For the purposes of sections 20AX and 20AY, where a resident person holds beneficial interest in a fund which is a partnership, the Commissioner takes the position that the mere fact that the resident person is a partner in the fund and the other partners in the fund are fellow partners of the resident person would not render the fund or the other partners in the fund "associates" of the resident person.

Ascertainment of deemed profits

158. The amount of the assessable profits deemed under section 20AX to have been derived by a resident person for a year of assessment commencing on or after 1 April 2019 is ascertained in accordance with Schedule 15C. The amount of the assessable profits deemed under section 20AY to have been derived by a resident person for a year of assessment commencing on or after 1 April 2019 is ascertained in accordance with Schedule 15D.

159. The amount of deemed assessable profits under section 20AX is the total sum arrived at by adding up the amount ascertained in accordance with the formula in section 2 of Part 1 of Schedule 15C for each day in the period in the year of assessment during which the resident person has the following percentage of direct or indirect beneficial interest in the fund:

(a) alone or jointly with the resident person's associates, not less than 30%; or

(b) any percentage if the fund is the resident person's associate.

160. The amount of deemed assessable profits under section 20AY is the total sum arrived at by adding up the amount ascertained in accordance with the formula in section 2 of Part 1 of Schedule 15D for each day in the period in the year of assessment during which the resident person has the following percentage of indirect beneficial interest in the SPE:

(a) alone or jointly with the resident person's associates, not less than 30%; or

(b) any percentage if the fund is the resident person's associate.

161. Section 2 of Part 1 of Schedule 15C sets out the following formula in ascertaining the amount of deemed assessable profits, out of the exempt profits of a fund, 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 fund for a particular day in a year of assessment

B means the extent of the resident person's beneficial interest in the fund on the particular day, expressed as a percentage determined in accordance with Part 2 of Schedule 15C

C means the exempt profits of the fund for the accounting period in which the particular day falls

D means the total number of days in the accounting period of the fund in which the particular day falls

162. In section 1 of Part 2 of Schedule 15C, the extent of a resident person's direct beneficial interest in the fund is determined as follows:

(a) the percentage of the issued share capital (however described) of the corporation held by the resident person (if the fund is a corporation that is not a trustee of a trust estate);

(b) the percentage of the profits of the partnership to which the

resident person is entitled (if the fund is a partnership that is not a trustee of a trust estate);

(c) the percentage in value of the trust estate in which the resident person is interested (if the fund is a trustee of a trust estate); or

(d) the percentage of ownership interests that the resident person has in the entity (if the fund is an entity that is not a corporation, a partnership or a trustee of a trust estate).

163. In section 2 of Part 2 of Schedule 15C, the extent of a resident person's indirect beneficial interest in the fund is determined as follows:

(a) if there is one interposed person – the percentage arrived at by multiplying the percentage of the resident person's beneficial interest in the interposed person by the percentage of the interposed person's beneficial interest in the fund; or

(b) if there is a series of two or more interposed persons – the percentage arrived at by multiplying the percentage of the resident person's beneficial interest in the first interposed person in the series by the percentage of the beneficial interest of each interposed person (other than the last interposed person) in the series in the next interposed person in the series and the percentage of the beneficial interest of the last interposed person in the series in the fund.

164. Section 2 of Part 1 of Schedule 15D sets out the following formula in ascertaining the amount of deemed assessable profits, out of the exempt profits of a SPE, of the resident person for a particular day in a year of assessment:

$$A = \frac{B1 \times B2 \times C}{D}$$

where– A means the exempt profits of the SPE for a particular day in a year of assessment

B1 means the extent of the resident person's beneficial interest in the fund on the particular day, expressed as a percentage determined in accordance with Part 2 of Schedule 15C

B2 means the extent of the fund's beneficial interest in the SPE on the particular day, expressed as a percentage determined in accordance with Part 2 of Schedule 15D

C means the exempt profits of the SPE for the accounting period of the SPE in which the particular day falls

D means the total number of days in the accounting period of the SPE in which the particular day falls

165. Section 1 of Part 2 of Schedule 15D provides that the extent of a fund's direct beneficial interest in the SPE is determined as follows:

(a) the percentage of the issued share capital (however described) of the corporation held by the fund (if the SPE is a corporation that is not a trustee of a trust estate);

(b) the percentage of the profits of the partnership to which the fund is entitled (if the SPE is a partnership that is not a trustee of a trust estate);

(c) the percentage in value of the trust estate in which the fund is interested (if the SPE is a trustee of a trust estate); or

(d) the percentage of ownership interests that the fund has in the entity (if the SPE is not a corporation, a partnership or a trustee of a trust estate).

166. A fund has an indirect beneficial interest in a SPE, if it 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 in the series and so on, and the last interposed person in the series has a direct beneficial interest in the SPE.

167. In section 2 of Part 2 of Schedule 15D, the extent of a fund's indirect beneficial interest in the SPE is determined as follows:

(a) if there is one interposed person – the percentage arrived at by multiplying the percentage of the fund's beneficial interest in the interposed person by the percentage of the interposed person's beneficial interest in the SPE; or

(b) if there is a series of 2 or more interposed persons – the percentage arrived at by multiplying the percentage of the fund's beneficial interest in the first interposed person in the series by the percentage of the beneficial interest of each interposed person (other than the last interposed person) in the series in the next interposed person in the series and the percentage of the beneficial interest of the last interposed person in the series in the SPE.

No deemed loss for resident persons

168. The anti-round tripping provisions are intended disincentives to a resident person for taking advantage of the profits tax exemption by carrying out round-tripping. In this regard, the anti-round tripping 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 fund or a SPE in which the resident person holds a beneficial interest.

169. A resident person may sustain losses in other businesses carried on in Hong Kong for the relevant year of assessment. Section 20AX 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 the 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 other businesses of the resident person in accordance with the provisions of section 19C depends on the status of the resident person. 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 fund is part and parcel of the other business of the resident person. The individual or partners of the partnership can, however, obtain the set-off under personal assessment, if applicable.

Provisions not applicable if bona fide widely held

170. Sections 20AX(8) and 20AY(7) provide that the anti-round tripping provisions do not apply to a resident person if the Commissioner is satisfied that beneficial interests in the fund concerned are bona fide widely held. These subsections are meant to be an escape route in case a resident person unintentionally holds a beneficial interest above the prescribed threshold in a fund that is bona fide widely held by investors.

171. The term "bona fide widely held" in sections 20AX(8) and 20AY(7) has also been adopted in sections 20AE(8) and 26A(1A) of the IRO. Likewise, the term "bona fide widely held" would be consistently interpreted as follows:

(a) 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, shares or interests in the fund; and

(b) 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 fund.

172. Where the above benchmark figures are not met, the Commissioner will still accept in practice that the "bona fide widely held" requirement has been satisfied if it is clear from the constitutive documents of the fund and other relevant materials 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. That is to say, there is nothing to suggest that the fund is intended to be a closely held investment vehicle. The "bona fide widely held" test applies to all funds though private equity funds by their nature are unlikely to be widely held. Sovereign wealth funds, pension funds, central banks and government agencies are separate and independent legal entities with different investment mandates. Within a private equity fund, each of them is regarded as an investor. The fact that an investor is a sovereign wealth fund, pension fund, central bank or government agency cannot turn the private equity fund into a widely-held investment vehicle. However, pension funds, central banks and government agencies resident outside Hong Kong may enjoy tax exemption under sections 20AC or 26A(1A) subject to the satisfaction of the conditions therein.

No double deeming

173. Sections 20AX(9) and 20AY(8) specifically provide that a resident person is not liable to tax in respect of the deemed assessable profits if the interposed resident person or any of the interposed resident persons through whom the resident person holds an indirect beneficial interest in a SPE is liable to tax under the anti-round tripping provisions in respect of the assessable profits of the same SPE.

Reporting requirements

174. Sections 20AX and 20AY impose tax liabilities on a resident person in respect of the deemed assessable profits earned by a fund and a SPE. Like other persons chargeable to tax, the resident person bears the legal obligation of complying with the provisions of the IRO on reporting chargeability, lodgement of returns, providing information, payment of tax, etc. Penalties under Part 14 of the IRO may be imposed for failures to comply with the relevant statutory provisions. In determining the tax liability of the resident person, the Assessor may be required to examine the fund constitutive documents and accounting records of the tax-exempted fund.

TAX ASSESSMENT

Assessment on funds and resident persons

175. Examples showing how assessments, if required, are raised on funds can be found at Appendix 4. Examples illustrating the way the anti-round tripping provisions are applied to resident persons are at Appendix 5.

TAXATION OF INVESTMENT MANAGER

176. The current practice relating to the taxation of investment managers remains unchanged. Paragraphs 72 to 78 of DIPN 51, relating to the application of anti-abuse provisions to the taxation of investment managers, continue to be followed.

TAX RESIDENCE

Tax residence of funds

177. A certificate of resident status is a document issued by the Hong Kong competent authority to a resident of Hong Kong who requires proof of resident status for the purposes of claiming tax benefits under a specific double taxation agreement or arrangement. If a fund is a resident of Hong Kong for the purposes of a specific double taxation agreement, then a certificate of resident status will be issued to the fund upon application.

178. In deciding whether a certificate of resident status should be issued to a fund, all the relevant issues have to be considered, including the business substance, the beneficial owner and the entitlement to benefits. In the absence of facts or circumstances showing that a fund's investment is part of an arrangement or relates to another transaction undertaken for a principal purpose of obtaining the benefit of a specific double taxation agreement or arrangement, it would not be reasonable for the treaty partner to deny the benefit to the fund issued with a certificate of resident status, showing that the fund is a resident of Hong Kong.

179. If the regional investment platform of a fund is located in Hong Kong for acquisition and management of a diversified portfolio of private market investments in various territories in a regional grouping that includes Hong Kong and the decision to establish the regional investment platform in Hong Kong is mainly driven by the availability of fund executives with knowledge of regional business practices and regulations, then the benefits under a double tax agreement or arrangement should be available to the fund.[14]

180. A private equity fund, which is usually structured as a limited partnership, is regarded as resident in Hong Kong if the central management and control of the limited partnership is exercised in Hong Kong. The fact that the general partner resides outside Hong Kong does not necessarily lead to the conclusion that the central management and control of the private equity fund is located outside Hong Kong. Where the central management and control of a private equity fund is exercised by the general partner, the residence of the private equity fund is the place where the central management and control is exercised by the general partner. Though the central management and control

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[14] Example K at paragraph 182 of the Commentary on Article 29 of the OECD Model Tax Convention on Income and Capital (10th edition of the condensed version).

may be exercised by the general partner in Hong Kong, the actual business operations of a private equity fund may take place outside Hong Kong.

181. For umbrella arrangements and sub-funds (e.g. protected cell companies), it would usually follow that each sub-fund has the same residence status as the overall arrangement. In the case of a corporation resident in Hong Kong, it is expected that each sub-fund would also be resident in Hong Kong if it is under the "central management and control" of the directors of the corporation which constitutes the overall arrangement. In the case of a trustee of a trust estate resident in Hong Kong, it is expected that each sub-fund would also be resident in Hong Kong if the "central management and control" of the trust estate which constitutes the overall arrangement is exercised in Hong Kong.

Tax residence of SPE

182. Since the operation of a SPE is very restrictive by definition (i.e. holding and administering investee private companies in the capacity of a shareholder), the place of residence of the SPE, wholly or partially owned by a private equity fund, generally follows that of the private equity fund despite that the SPE might be incorporated, registered or appointed in Hong Kong.

183. The certificate of resident status would only be issued to a SPE as a proof of its resident status for claiming tax benefits under the relevant double taxation agreement or arrangement if it can be proved that the SPE is resident in Hong Kong. In deciding whether a certificate of resident status could be issued to a SPE, all the facts and circumstances would be examined to determine whether the SPE has substantial business activities in Hong Kong (e.g. whether the SPE has a permanent office or employs staff in Hong Kong to hold and administer its investment in investee private companies).

184. The issue of a certificate of resident status will be refused if the SPE is a mere conduit. In such a case, the SPE will not be regarded as a resident of Hong Kong. The issue of a certificate of resident status to a SPE will not guarantee that it will be successful in its claim to treaty benefits. The decision as to whether relief from foreign taxes can be granted is, ultimately, one to be made by the treaty partner. It will be up to the treaty partner to determine whether all the relevant conditions are fulfilled and whether the benefits should be granted.

Appendix 1

Major Features of an Open-Ended Fund Company

Legal framework for the open-ended fund company

1. To diversify the fund management platform, a legal framework for a fund structure in the form of open-ended fund company (OFC) has been put in place in Hong Kong. The OFC regime allows funds to be set up in corporate form. The OFC regime, commenced on 30 July 2018, is implemented through the following:

(a) the Securities and Futures (Amendment) Ordinance 2016 which provides a legal framework for the OFC regime and empowers the Securities and Futures Commission (SFC) to issue codes and guidelines in relation to the regulation of OFCs;

(b) the Securities and Futures (Open-ended Fund Companies) Rules (Cap. 571AQ) (OFC Rule) which set out the detailed statutory requirements concerning an OFC's formation and maintenance, appointment and cessation of appointment of key operators of an OFC (i.e. the directors, investment manager and custodian), the functions of the Registrar of Companies (CR) (primarily in respect of incorporation and corporate filings), the segregated liability feature of sub-funds of OFCs, winding-up, and offences;

(c) the Securities and Futures (Open-ended Fund Companies) (Fees) Regulation (Cap. 571AR) which concerns the fees charged by the SFC and the Registrar of Companies; and

(d) the Code on Open-Ended Fund Companies (OFC Code), which is made under section 112ZR of the Securities and Futures Ordinance (Cap. 571) (SFO), provides guidelines in respect of matters relating to the registration, management, and operation of OFCs and their business.

2. The SFC, being the principal regulator, is responsible for the registration and regulation of OFCs. The CR oversees the incorporation and statutory corporate filings of OFCs.

Structure and key features

3. An OFC is an open-ended collective investment scheme, which is structured in corporate form with limited liability and variable share capital. The OFC structure has characteristics similar to a conventional limited company in that it has a legal personality; it has a constitutional document, namely the Instrument of Incorporation; it is governed by a board of directors who are subject to fiduciary duties; and the liabilities of its shareholders are limited to the amount unpaid on their shares in the OFC. The OFC could be a publicly[1] or privately[2] offered fund.

4. However, being an investment vehicle, an OFC should not be:

(a) bound by restrictions on the reduction of share capital applicable to companies formed under the Company Ordinance (Cap. 622) (CO), and instead will have the flexibility to vary its share capital in order to meet shareholder subscription and redemption requests;

(b) bound by restrictions on distribution out of share capital applicable to companies formed under the CO and instead, may distribute out of share capital subject to solvency and disclosure requirements; and

(c) required to be licensed as a licensed corporation under the SFO, but will have to be registered with the SFC, and should delegate its investment management functions to an investment manager who is appointed by the OFC board.

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1 A publicly offered OFC is a fund that is offered for sale to the public in Hong Kong and should be subject to the authorization of the SFC.

2 A privately offered OFC is a fund that is not offered for sale to the public in Hong Kong and is not subject to the authorization of the SFC.

Key operators

5. The directors, the investment manager and the custodian are the key operators of an OFC. The key operators have to meet some basic eligibility requirements. The OFC board is legally responsible for all the affairs of the OFC and will provide an additional layer of oversight for shareholders. As the investment management functions of the OFC are delegated to an investment manager, individual directors of the OFC board will not be required to be licensed under the SFO. While there is no requirement for the directors to be residents of Hong Kong, each of the non-resident directors of the OFC should appoint a process agent in Hong Kong to accept service of process. Also, the investment managers are required to be those licensed by or registered with the SFC to carry out a Type 9 regulated activity.

6. The assets of an OFC must be segregated from those of the investment manager and entrusted to a separate, independent custodian for safekeeping. Aside from a custodian incorporated in Hong Kong, an OFC may also appoint an overseas custodian, provided that it has a place of business or an agent in Hong Kong for the purpose of accepting the service of notices and legal documents in Hong Kong.

Investment scope and fund operation

7. A publicly offered OFC is allowed by the SFC to invest in asset classes in accordance with the SFC's product code requirements and authorization conditions (i.e. mainly in securities and futures). A privately offered OFC is allowed by the SFC to invest in asset classes in accordance with the OFC Code[3].

8. An OFC may also be created as an umbrella fund meaning that the OFC could consist of a number of separately pooled sub-funds and each sub-fund would have a pool of assets that is managed in accordance with the investment objectives and policies for that particular sub-fund. Further, a protected cell structure is made available for an OFC, such that the assets of a sub-fund of an umbrella OFC belong exclusively to that sub-fund and shall not

[3] According to the OFC Code published in July 2018, a privately offered OFC must invest at least 90% of its gross asset value in those asset types the management of which would constitute a Type 9 regulated activity (i.e. mainly securities and futures) contracts, and/ or cash, bank deposits, certificates of deposit, foreign currencies and foreign exchange contracts. A privately offered OFC may also invest in other asset classes, but only up to 10% of its gross asset value.

be used to discharge the liabilities of or claims against the umbrella OFC or any other sub-fund.

Incorporation and registration of an OFC

9. To incorporate an OFC, the applicant (e.g. a proposed director, senior executive of investment manager) should apply to the SFC for registration prior to applying to the CR for incorporation. Once the SFC is satisfied that the registration requirements are met, it will issue a notice of registration to the CR. The CR will incorporate an OFC if it has received the notice of registration and other relevant documents from the SFC and is satisfied that the requirements for incorporation have been met. The registration of the OFC will take effect only on the day of issue of the certificate of incorporation by the CR.

10. An OFC is required to register under the Business Registration Ordinance (Cap. 310). Under the one-stop company incorporation and business registration service, the CR will issue to the OFC the first business registration certificate on behalf of the Commissioner simultaneously together with the certificate of incorporation. A sub-fund of an OFC is not required to apply for a branch registration. Where the business of an OFC is carried on at more than one address, the OFC is required to apply for branch registration in respect of the business carried on at the place other than its main business address.

Filing obligations of an OFC after incorporation

11. As an OFC is incorporated under the SFO, the OFC will be subject to the filing obligations under the SFO and the OFC Rules (rather than the CO). The CR is responsible for the administration of statutory corporate filings of an OFC, keeping records of information relating to an OFC and the provision to the public with services to access the OFC information that it holds. Details on the filing obligations of an OFC after incorporation and search on OFC information can be found at the CR's website (www.cr.gov.hk). More information can be found at the SFC's website (www.sfc.hk).

Termination of OFC

12. Under section 112ZH of the SFO, an OFC may apply to the SFC for cancellation of registration voluntarily upon termination (voluntary termination).

The OFC must follow all applicable procedures in the OFC Rules and OFC Code in relation to an application for a voluntary termination. After the OFC's assets have been fully realized, all liabilities have been settled and proceeds have been distributed to shareholders of the OFC, the board of directors can submit relevant documents to the SFC and apply for cancellation of registration of the OFC. When submitting an application for cancellation of registration of the OFC, the board of directors should ensure that the OFC has no outstanding tax liabilities by obtaining a tax clearance letter from the Department.

Appendix 2

Classes of Assets for Qualifying Transactions

List of classes of assets

1. Part 1 of Schedule 16C to the Inland Revenue Ordinance (IRO) contains a list of 11 classes of assets specified for transactions for the purposes of section 20AN:

(a) securities;

(b) shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a private company;

(c) futures contracts;

(d) foreign exchange contracts under which the parties to the contracts agree to exchange different currencies on a particular date;

(e) deposits other than those made by way of a money-lending business;

(f) deposits (as defined by section 2(1) of the Banking Ordinance (Cap. 155)) made with a bank (as defined by Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571) (SFO);

(g) certificates of deposit (as defined by Part 1 of Schedule 1 to the SFO);

(h) exchange-traded commodities;

(i) foreign currencies;

(j) OTC derivative products (as defined by Part 1 of Schedule 1 to the SFO);

(k) an investee company's shares co-invested by a partner fund and The Innovation and Technology Venture Fund Corporation (ITVFC) under the Innovation and Technology Venture Fund (ITVF) Scheme.

Definitions and interpretation

2. The relevant definitions and their interpretation of the classes of assets for qualifying transactions are set out in the ensuing paragraphs.

Securities

3. In section 1 of Part 2 of Schedule 16C, "securities" is defined to mean:

(a) subject to section 21(6) of Schedule 17A (specified alternative bond scheme and its tax treatment), shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a body (including a special purpose entity), whether incorporated or unincorporated, or a government or municipal government authority;

(b) rights, options or interests (whether described as units or otherwise) in, or in respect of, such shares, stocks, debentures, loan stocks, funds, bonds or notes;

(c) certificates of interest or participation in, temporary or interim certificates for, receipts for, or warrants to subscribe for or purchase, such shares, stocks, debentures, loan stocks, funds, bonds or notes;

(d) interests in any collective investment scheme;

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

(f) a structured product in respect of which the issue of any advertisement, invitation or document that is or contains an invitation to the public to do any act referred to in section 103(1)(a) of the SFO is authorized, or required to be authorized, under section 105(1) of that Ordinance.

4. For the purposes of paragraphs 3(a), (b) and (c) above in the definition of "securities", a regulatory capital security is treated as a bond. Section 20AN(7) provides that section 21 of Schedule 17A provides for modifications to that section.

5. Section 1 of Part 2 of Schedule 16C also contains definitions of "collective investment scheme", "debenture" and "share" in relation to the meaning of "securities".

6. The term "collective investment scheme" is defined in section 1 of Part 2 of Schedule 16C. The meaning of "collective investment scheme" aligns with the meaning of "fund" in section 20AM(2) and is similar to that of "collective investment scheme" set out in section 1 of Part 1 of Schedule 1 to the SFO. Interest in a private equity fund in the form of a limited partnership could constitute "securities" so long as the private equity fund falls within the meaning of "collective investment scheme".

7. The term "debenture", as defined in section 1 of Part 2 of Schedule 16C, includes debenture stocks, bonds, and other debt securities of a corporation (whether constituting a charge on the assets of the corporation or not). In this context, the term "other debt securities" covers bills of exchange, promissory notes or instruments which evidence an obligation to pay a stated or determinable amount of money to the bearer or to the bearer's order, on or before a fixed time, with or without endorsement, and the right to receive that stated or determinable amount of money, with or without interest, is transferable. Loans or distressed debts structured in the form of securities are assets of a Schedule 16C class.

8. The term "share" is defined to mean any shares in the share capital of a corporation, and, except where a distinction between stock and shares is expressed or implied, includes stock.

Shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a private company

9. In this context, the term "private company", as defined in section 20AO(4), means 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.

Futures contracts

10. "Futures contract" is defined to mean:

(a) a contract or an option on a contract made under the rules or convention of a futures market; 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;

(ii) that an authorized institution within the meaning of the Banking Ordinance (Cap. 155) (BO) 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.

11. In relation to paragraph 10(b) above in the definition of "futures contract", the term "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 (e.g. cash-settled commodity futures contract, Hang Seng Index futures contract, etc.).

12. 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.

Foreign exchange contracts

13. "Foreign exchange contract" is a contract under which the parties to the contract agree to exchange different currencies on a particular 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.

Deposit other than by way of a money-lending business

14. "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.

15. Funds in the normal course of business may hold money deposits in their asset portfolios. This asset class covers the holding of such money deposits, which may be in any currency. As clearly provided, this asset class 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 IRO, it has been decided in tax cases that in determining whether a money-lending business is carried on, the absence of 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. Though "deposit" is defined to mean "a loan of money", this asset class "deposit other than by way of a money-lending business" should not cover "loan", whether made out or acquired as investment.

Exchange-traded commodities

16. "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 (Cap. 82) (CEPO) 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) of the CEPO refers to a commodity exchange which was in operation on 20 June 1973. The Chinese Gold and 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 transactions therefore covers transactions in gold or silver traded on the Chinese Gold and Silver Exchange Society.

Foreign currencies

17. Transactions in "foreign currencies" cover spot transactions in foreign currencies (transactions in exchanging currencies at a future time are covered by "transaction in foreign exchange contracts") and transactions in exchanging foreign currencies from or to Hong Kong dollars.

OTC derivative products

18. An "OTC derivative product" is defined in section 1B(1) in Part 1 of Schedule 1 to the SFO to mean a structured product, subject to a number of exclusions under section 1B(2) and inclusion in section 1B(3). This definition is added to this Schedule by the Securities and Futures (Amendment) Ordinance 2014, which seeks to establish a framework for regulation of over-the-counter derivative products and transactions. The definitions of "OTC derivative products" and "OTC derivative transactions" came into effect on 10 July 2015.

ITVF Scheme

19. An investee company's shares co-invested by a partner fund and ITVFC under the ITVF Scheme is one of the classes of assets for qualifying transactions. On and after 1 April 2019, a partner fund, whether onshore or offshore, joining the ITVF Scheme, is eligible for tax exemption under section 20AN in respect of profits derived from co-investment transactions in an investee company's shares subject to the following condition:

(a) the co-investment transactions have been carried out in Hong Kong by or through a specified person (as defined in section 20AN(6)) or arranged in Hong Kong by a specified person; or

(b) the partner fund is a qualified investment fund (as defined in section 20AN(6).

20. Section 20AR specifies that the co-investment transactions do not need to be subject to the tests in sections 20AP and 20AQ.

21. An investee company as defined in section 20AR(2) means:

(a) a corporation that has ITVFC and a partner fund as shareholders under the ITVF Scheme; or

(b) a corporation that–

(i) had, at any time, ITVFC and a partner fund (Fund A) as shareholders under the ITVF Scheme; and

(ii) has, since that time, continued to have a partner fund (whether Fund A or another partner fund) as a shareholder.

22. A partner fund is also defined in section 20AR(2) and means a fund that is a party (whether or not through an agent) to an agreement:

(a) to which ITVFC is also a party;

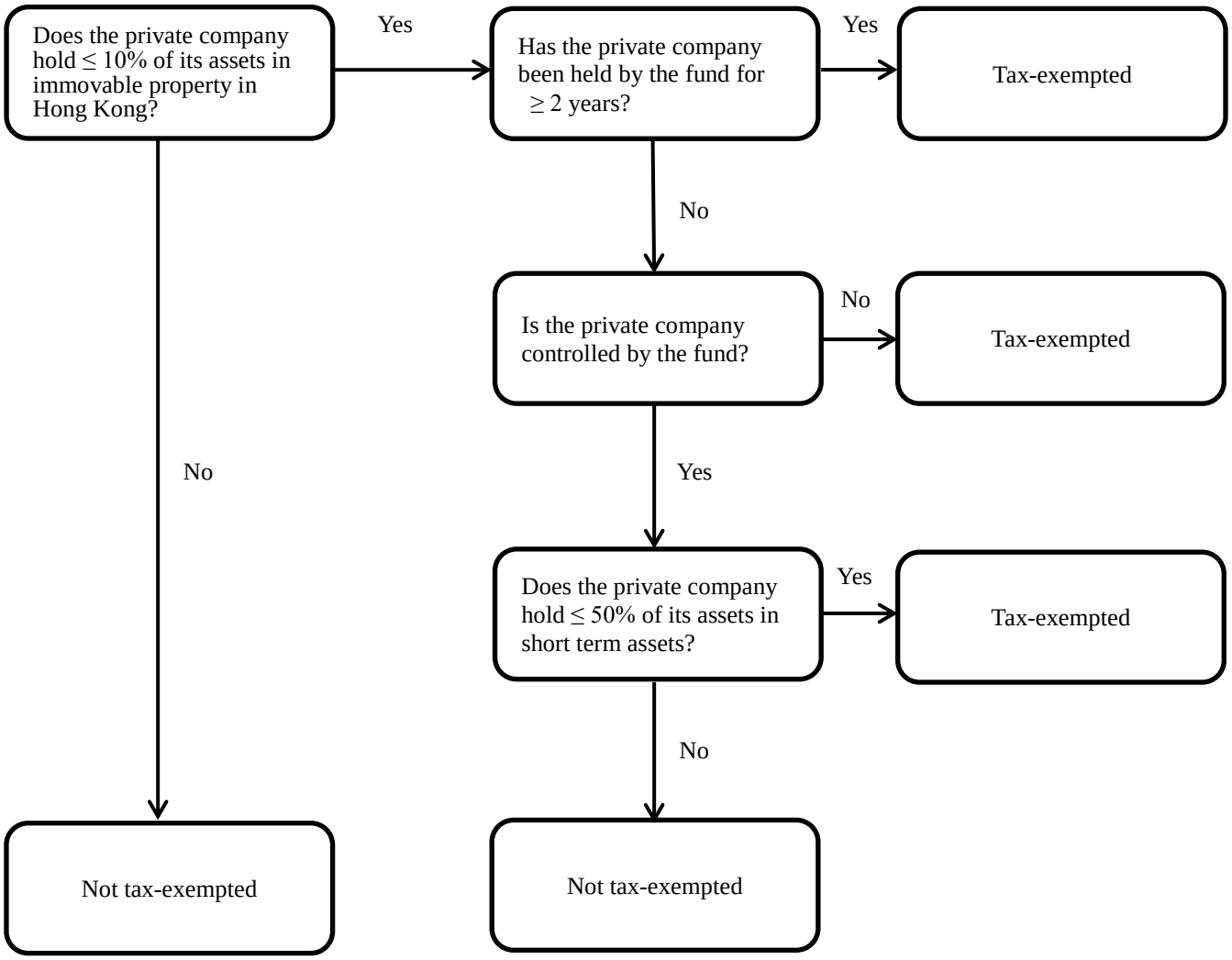
(b) that stipulates the overall rights and obligations of ITVFC and the fund in respect of their participation in the ITVF Scheme; and

(c) that is valid and in force.

List of partner funds (or co-investment funds) can be found at the website of ITVF administered by the Information and Technology Commission (www.itf.gov.hk/l-eng/ITVF_Partners.asp).

Appendix 3

Tests on Eligibility for Tax Exemption in Respect of Profits Generated from Transactions in Specified Securities of a Private Company



Appendix 4

Examples on Raising Assessments on Funds

1. The exemption provisions in section 20AN apply to a fund as defined in section 20AM. Though a business undertaking for general commercial or industrial purposes is not a fund, the exemption provisions in section 20AC may apply to a non-resident business undertaking.

Example 4.1

Contractual Arrangement-F1 was established and resident in Jurisdiction-F1 with five investors. In the year of assessment 2019/20, Contractual Arrangement-F1 carried out in Hong Kong through a specified person the following transactions:

Schedule 16C transactions[1] and incidental transactions (≤5%)	***Non-Schedule 16C[2] transactions***
Profits of $5m	*Profits of $4m*

If Contractual Arrangement-F1 was or constituted a business undertaking for general commercial or industrial purposes as elaborated in section 20AM(6) and (7), then Contractual Arrangement-F1 would not be regarded as a "fund" under section 20AM for the purposes of tax exemption. However, the provisions in section 20AC would be applicable to Contractual Arrangement-F1, subject to the conditions therein, if it was a non-fund person resident outside Hong Kong.

If the non-Schedule 16C transactions related to assets which were normally purchased and sold in the normal course of business of a commercial or industrial enterprise, in particular those mentioned in section 20AM(7), then Contractual Arrangement-F1 might be a business undertaking, depending on the facts and circumstances.

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1 "Schedule 16C transactions" means transactions in assets of a class specified in Schedule 16C.

2 "Non-Schedule 16C transactions" means transactions in assets of a class that is not specified in Schedule 16C.

If Contractual Arrangement-F1 fell within the definition of "fund" in section 20AM, tax exemption on profits of $5m derived from Schedule 16C transactions and incidental transactions would be allowed under section 20AN(2)(a) and (b). Profits tax assessment for the year of assessment 2019/20 would be raised on Contractual Arrangement-F1 in respect of profits derived from non-Schedule 16C transactions.

2. Profits derived by a fund from Schedule 16C transactions carried out or arranged in Hong Kong and incidental transactions thereof are chargeable to profits tax if not because of the exemption provided in section 20AN. The fund is exempt from payment of tax in respect of profits derived from the Schedule 16C transactions and incidental transactions thereof if the Schedule 16C transactions are carried out in Hong Kong by or through a specified person or arranged in Hong Kong by a specified person. Profits derived by a fund from non-Schedule 16C transactions carried out or arranged in Hong Kong are chargeable to profits tax. Specified person is not required if the fund is a qualified investment fund.

Example 4.2

Limited Partnership-F2, resident in Jurisdiction-F2, was established as an investment fund and fell within the definition of "fund" in section 20AM. In the year of assessment 2019/20, Limited Partnership-F2 carried out or arranged in Hong Kong the following transactions:

Schedule 16C transactions and incidental transactions (≤5%)	***Non-Schedule 16C transactions***
Profits of $10m	*Profits of $5m*

If the non-Schedule 16C transactions related to assets which were normally purchased and sold in the normal course of business of a commercial or industrial enterprise, in particular those mentioned in section 20AM(7), then Limited Partnership-F2 might in fact constitute a business undertaking, depending on the facts and circumstances.

If the Schedule 16C transactions were carried out in Hong Kong by or through a specified person or arranged in Hong Kong by a specified person, then tax exemption on profits of $10m derived from the Schedule 16C transactions and incidental transactions would be allowed under section 20AN(2)(a) and (b).

If the Schedule 16C transactions were not carried out in Hong Kong by or through a specified person or arranged in Hong Kong by a specified person, then tax exemption on profits of $10m derived from the Schedule 16C transactions and incidental transactions would not be allowed under section 20AN(2)(a) and (b) unless Limited Partnership-F2 was a qualified investment fund as defined in section 20AN(6).

Profits tax assessment for the year of assessment 2019/20 would be raised on Limited Partnership-F2 in respect of profits derived from the non-Schedule 16C transactions.

3. Profits derived by a fund which is an open-ended fund company (OFC) from Schedule 16C transactions and incidental transactions thereof would be exempt from profits tax under section 20AN(2)(a) and (b) if the Schedule 16C transactions are carried out in Hong Kong by or through a specified person or arranged in Hong Kong by a specified person. Section 112Z of the Securities and Futures Ordinance (Cap. 517) (SFO) requires an OFC to have an investment manager who is responsible for managing the scheme property of the company. The investment manager of the OFC is required to be licensed or registered for a Type 9 regulated activity.

4. Profits derived by a fund which is an OFC from non-Schedule 16C transactions would be exempt from profits tax under section 20AN(2)(c) unless such profits were derived from:

(a) direct trading or direct business undertaking in Hong Kong; or

(b) utilization of non-Schedule 16C assets held to generate income.

Example 4.3

OFC-HK1 was incorporated in Hong Kong on 1 April 2019. At all times, OFC-HK1 complied with the 10% de minimis rule as set out in the Securities and Futures Commission's (SFC) Code on Open-Ended Fund Companies (OFC Code). During the year of assessment 2019/20, OFC-HK carried out in Hong Kong, through an investment manager licensed for a Type 9 regulated activity as required under the OFC Code, the following transactions:

Schedule 16C transactions and incidental transactions (≤5%)	***Non-Schedule 16C transactions***
Profits of $10m	*Profits of $5m*

OFC-HK1, subject to the regulatory requirements of the SFC, would be accepted as a fund under section 20AM for the purposes of tax exemption.

Tax exemption on profits of $10m derived from the Schedule 16C transactions and incidental transactions would be allowed under section 20AN(2)(a) and (b). Tax exemption on profits of $5m derived from the non-Schedule 16C transactions would also be granted under section 20AN(2)(c) unless such profits were derived from direct trading or direct business undertaking in Hong Kong or utilization of non-Schedule 16C assets held to generate income.

No profits tax assessment would be raised on OFC-HK1 for the year of assessment 2019/20.

Example 4.4

OFC-HK2 was incorporated in Hong Kong on 1 April 2019. At all times, OFC-HK2 complied with the 10% de minimis rule as set out in the SFC's OFC Code. During the year of assessment 2019/20, OFC-HK2 carried out the following transactions:

Schedule 16C transactions and incidental transactions (≤5%)	***Non-Schedule 16C transactions***
Profits of $15m	*Direct trading profits of $10m*

OFC-HK2, subject to the regulatory requirements of the SFC, would be accepted as a fund under section 20AM for the purposes of tax exemption.

If the Schedule 16C transactions were carried out in Hong Kong by or through a specified person or arranged in Hong Kong by a specified person, tax exemption on profits of $15m derived from the Schedule 16C transactions and incidental transactions would be allowed under section 20AN(2)(a) and (b).

Profits of $10m derived from the non-Schedule 16C transactions would not be exempt from profits tax under section 20AS since such profits were derived from direct trading of non-Schedule 16C assets.

Profits tax assessment would be raised on OFC-HK2 for the year of assessment 2019/20 in respect of profits derived from direct trading of non-Schedule 16C assets.

5. The assessable profits of an umbrella OFC would be the total of the assessable profits of all of its sub-funds, each of which would be regarded as an OFC for computing assessable profits of the sub-fund.

Example 4.5

OFC-HK3 was incorporated in Hong Kong under Part IVA of SFO on 1 April 2019. Sub-Fund A and Sub-Fund B were the sub-funds of OFC-HK3. OFC-HK3 was a privately offered OFC subject to the regulatory requirements of the SFC. At all times, OFC-HK3, Sub-Fund A and Sub-Fund B complied with the Securities and Futures (Open-ended Fund Companies) Rules (OFC Rules) and OFC Code (including the 10% de minimis rule). During the year of assessment 2019/20, Sub-Fund A and Sub-Fund B carried out in Hong Kong, through a specified person, the following transactions:

	Schedule 16C transactions and incidental transactions (≤5%)	***Non-Schedule 16C transactions***
Sub-Fund A	*Profits of $1m*	*Loss of $2m*
Sub-Fund B	*Loss of $0.5m*	*Profits of $2m*

Insofar as OFC-HK3, Sub-Fund A and Sub-Fund B were concerned, they complied with the OFC Rules and the OFC Code (including the 10% de minimis rule). Since at all times during the year of assessment they complied with the OFC Code, they would be accepted as funds under section 20AM for the purposes of tax exemption.

Profits from the Schedule 16C transactions and incidental transactions would be exempt from tax under section 20AN(2)(a) and (b). Profits from the non-Schedule 16C transactions would also be exempt under section 20AN(2)(c) from tax unless such profits were derived from direct trading or direct business undertaking in Hong Kong or utilization of non-Schedule 16C assets held to generate income.

Tax treatment of OFC-HK3, Sub-Fund A and Sub-Fund B for the year of assessment 2019/20 would be as follows:

<u>Sub-Fund A</u>

Tax exemption on profits of $1m from the Schedule 16C transactions and incidental transactions would be allowed. Since profits derived from the non-Schedule 16C transactions would have been tax exempted under section 20AN(2)(c), the loss of $2m incurred in the year of assessment 2019/20 from the non-Schedule 16C transactions would not be carried forward under section 20AV(2) to set off against any of its assessable profits in any subsequent year of assessment.

<u>Sub-Fund B</u>

Tax exemption in respect of profits of $2m derived from the non-Schedule 16C class would be allowed under section 20AN(2)(c) unless assessable under section 20AS. Since profits derived from the Schedule 16C transactions and incidental transactions would have been tax exempted under section 20AN(2)(a) and (b), loss of $0.5m

derived from the Schedule 16C transactions and incidental transactions would not be carried forward under section 20AV(2) to set off against any of its profits in any subsequent year of assessment.

OFC-HK3

Profits tax assessment, if any, would be issued under section 20AT(2) in the name of HK-OFC3. OFC-HK3's tax liability would be the aggregate amount of tax liability, if any, of each of its sub-funds (i.e. Sub-Fund A and Sub-Fund B). For the year of assessment 2019/20, neither profits tax assessment nor statement of loss would be issued to OFC-HK3.

Appendix 5

Examples on Applying the Anti-round Tripping Provisions

1. When applying the anti-round tripping provisions in section 20AX(1) relating to a fund which has profits exempted from tax under section 20AN, reference has to be made to a resident person's beneficial interest:

(a) both direct and indirect beneficial interests are to be taken into account; and

(b) beneficial interests held by associates are to be taken into account.

Example 5.1

Company-HK1, a company resident in Hong Kong, held directly 20% and indirectly 15%, through other persons, of the issued share capital of Mutual Fund Corp-F1. Mutual Fund Corp-F1 was a mutual fund corporation established and resident in Jurisdiction-F1, having profits exempted from tax under section 20AN.

Company-HK1's direct and indirect beneficial interests in Mutual Fund Corp-F aggregated 35% (i.e. 20% + 15%), exceeding the threshold of "not less than 30%" in section 20AX(2). Per section 20AX(1), 35% of the profits of Mutual Fund Corp-F1 exempted from tax under section 20AN would be deemed to be the assessable profits of Company-HK1.

Example 5.2

Company-HK2 and Company-HK3 were companies resident in Hong Kong. They were subsidiaries of Holding Company-F2, resident in Jurisdiction-F2. Company-HK2 and Company-HK3 held 20% and 25% respectively of the issued share capital of Mutual Fund Corp-F2, a mutual fund corporation, resident in Jurisdiction-F2, having profits exempted from tax under section 20AN.

Company-HK2 and Company-HK3 were associated corporations and were therefore associates under section 20AN(6). Since their beneficial interests in Mutual Fund Corp-F2 equalled in total 45% (i.e. 20% + 25%), exceeding the threshold of "not less than 30%", 20% and 25% of the profits of Mutual Fund Corp-F2 exempted under section 20AN would be deemed to be the assessable profits of Company-HK2 and Company-HK3 respectively.

Though Holding Company-F2, having indirect beneficial interests in Mutual Fund Corp-F2, was resident outside Hong Kong, the anti-round tripping provisions would apply since Company-HK2 and Company-HK3 were residents in Hong Kong.

Example 5.3

Facts were the same as those in Example 5.2 except that Company-HK3 was a company resident outside Hong Kong.

Per section 20AX(2), the beneficial interest of Company-HK2, a person resident in Hong Kong, would include the issued share capital of Mutual Fund Corp-F2 held by Company-HK2 and Company-HK3 even though Company-HK3 was an associate of Company-HK2 resident outside Hong Kong.

Since the total beneficial interests of Company-HK2 in Mutual Fund Corp-F2 amounted to 45% (i.e. 20% + 25%), exceeding the threshold of "not less than 30%", 20% of the profits of Mutual Fund Corp-F2 exempted under section 20AN would be deemed to be the assessable profits of Company-HK2. No profits of Mutual Fund Corp-F2 exempted under section 20AN would be deemed to be the assessable profits of Company-HK3 since the anti-round tripping provisions were not to be applied to a non-resident.

2. The anti-round tripping provisions in section 20AX(3) would apply in respect of any percentage of beneficial interests held in a fund which is an associate of a resident person.

Example 5.4

Fund(LP)-F3, established as a limited partnership, was a private equity fund resident in Jurisidiction-F3. Company-HK4, a company resident in Hong Kong, was entitled to 20% of the profits of Fund(LP)-F3. Fund(LP)-F3 was an associate of Company-HK4 and had profits exempted from tax under section 20AN.

The anti-round tripping provisions in section 20AX(1) would not apply since the beneficial interest of Company-HK4 in Fund(LP)-F3 was less than 30%. However, the anti-round tripping provisions in section 20AX(3) would apply since Fund(LP)-F3 was an associate of Company-HK4. All profits of Fund(LP)-F3 exempted from tax under section 20AN would be deemed to be the assessable profits of Company-HK4.

Example 5.5

Facts were the same as those in Example 5.4 except that Fund(LP)-F3 was not an associate of Company-HK4. Company-HK4 was entitled to 20% and 35% of the profits of Fund(LP)-F3 in the years of assessment 2019/20 and 2020/21 respectively.

The anti-round tripping provisions in section 20AX(1) would not apply in the year of assessment 2019/20 since the beneficial interest of Company-HK4 in Fund(LP)-F3 was less than 30%. However, the anti-round tripping provisions would apply in the year of assessment 2020/21 since the beneficial interest of Company-HK4 in Fund(LP)-F3 was not less than 30%. 35% of the profits of Fund(LP)-F3 exempted from tax under section 20AN would be deemed to be the assessable profits of Company-HK4 for the year of assessment 2020/21.

3. When applying the anti-round tripping provisions in section 20AX(1) or section 20AY(1), the deemed assessable profits of a resident person would be the total sum arrived at by adding up:

(a) the profits of the fund exempted under section 20AN for each day in the period during which the resident person has a direct or indirect interest of not less than 30% in the fund; and

(b) the profits of the special purpose entity exempted under section 20AO for each day in the period during which the resident person has an indirect interest of not less than 30% in the special purpose entity.

Example 5.6

On 1 October 2019, Company-HK5, a company resident in Hong Kong, acquired an interest of 20% in value of the trust estate of Fund(T)-F4. Fund(T)-F4, structured in the form of a trust, was resident in Jurisdiction-F4. Fund(T)-F4 was not an associate of Company-HK5. Company-HK5 and its associates had no other beneficial interest in Fund(T)-F4.

Company-SPE was a special purpose entity wholly owned by Fund(T)-F4. It was used to hold Company-F5 which was an investee private company in Jurisdiction-F5. On 1 January 2020, Company-HK5 purchased a further interest of 30% in Fund(T)-F4. Fund(T)-F4 closed its accounts on 31 March every year.

In the year ended 31 March 2020, Fund(T)-F4 derived profits of $80m, excluding distributions from Company-SPE, which were exempted from tax under section 20AN. Company-SPE derived profits of $100m from disposal of shares in Company-F5 which were exempted from tax under section 20AO.

Deemed assessable profits of Company-HK5 for the year of assessment 2019/20 would be computed as follows:

[$80m × 50% × (91 days ÷ 366 days)] + [$100m × 50% × 100% × (91 days ÷ 366 days)] = $22.4m

Number of days from 1 January 2020 to 31 March 2020 was 91. Days from 1 April 2019 to 31 December 2019 would not be taken into

account since Company-HK5 held a beneficial interest of 20% (i.e. less than 30%) in Fund(T)-F4 during this period.

4. If an interposed person is a resident person who is liable to tax in respect of the profits deemed assessable under section 20AX(1) or (3), then the resident person liable to tax under section 20AX(1) or (3) because of the resident person's indirect beneficial interest in a fund through that interposed person would be discharged from liability per section 20AX(9). Equally, if an interposed person is a resident person who is liable to tax in respect of the profits deemed assessable under section 20AY(1) or (2), then the resident person liable to tax under section 20AY(1) or (2) because of the resident person's indirect beneficial interest in a SPE through that interposed person would be discharged from liability per section 20AY(8).

Example 5.7

Company-HK6 held 90% of the share capital of Company-HK7 which in turn held 70% of the share capital of Company-HK8. Company-HK6, Company-HK7 and Company-HK8 were companies resident in Hong Kong.

Company-HK8 held 50% of the ownership interest in Investment Fund-F5 which was an entity not structured in the form of a corporation, partnership or trust. Investment Fund-F5, a fund resident in Jurisdiction-F5, in turn held an investee private company through Company-SPE, a wholly owned special purpose entity.

Investment Fund-F5 was exempted from payment of tax in respect of profits derived from transactions in securities under section 20AN. Company-SPE was exempted from payment of tax in respect of profits derived from sale of specified securities issued by the investee private company under section 20AO.

Per sections 20AX(1) and 20AY(1), 50% of the profits of Investment Fund-F5 exempted from tax under section 20AN and 50% of the profits of Company-SPE exempted from tax under section 20AO would be deemed to be the assessable profits of Company-HK8.

Since Company-HK8 was liable to tax on the deemed assessable profits, Company-HK6 and Company-HK7 would be discharged from liability to tax per sections 20AX(9) and 20AY(8) notwithstanding that they both held indirect beneficial interests of more than 30% (i.e. Company-HK6: 90% × 70% × 50% = 31.5%; Company-HK7: 70% × 50% = 35%) in Investment Fund-F5.