Boosting Hong Kong’s competitiveness in the BEPS era

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Abstract

In the Group of Twenty (G20) leaders’ meeting in June 2012, the finance ministers of the participating nations commissioned the Organization for Economic Co-operation and Development (OECD) to conduct a study and report on Base Erosion and Profit Shifting (BEPS). In July 2013, OECD and G20 countries adopted a 15-point Action Plan to address BEPS. After a 2-year consultation period, the OECD presented the final package of anti-BEPS measures addressing all of the 15-point Action Plan in October 2015. Since then, many tax jurisdictions have introduced new initiatives to enhance tax transparency and combat cross-border tax evasion. Hong Kong is committed to cooperate with the international community to combat BEPS. On 26 October 2016, Hong Kong issued a consultation paper on proposed measures to counter BEPS. The consultation paper focuses on the OECD minimum standards as well as other actions which are in line with the priorities and broader roadmap of Hong Kong on anti-BEPS strategy. Recently, Hong Kong introduced a set of tax and non-tax measures so as to elevate its competitive position. These measures include: (1) extending the profits tax exemption for offshore funds to private equity funds on 17 July 2015, (2) enacting a concessionary tax regime for qualifying corporate treasury centers on 3 June 2016, and (3) launching the Shenzhen-Hong Kong Stock Connect on 5 December 2016. Using a legal research methodology, this study examines these new measures and evaluates their impacts on the international competitiveness of Hong Kong. Major concluding observations are as follows. The OECD final package of the 15-point Action Plan is not the end but only part of the journey in tackling BEPS. In the BEPS era, it is important that different jurisdictions cooperate with each other and introduce domestic laws and regulations to implement the OECD recommendations. The recent tax measures in Hong Kong on the offshore funds and corporate treasury centers will enhance Hong Kong’s
competitiveness in attracting offshore funds to be managed in Hong Kong and uplift Hong Kong’s status as an attractive regional corporate treasury center. Also, the official launch of Shenzhen-Hong Kong Connect and the Shanghai-Hong Kong Connect will strengthen Hong Kong’s strategic role as a platform for international investors to access the Mainland China capital markets and Mainland China investors to go aboard. In sum, these measures are conducive to Hong Kong’s economic growth and enhance its overall competitiveness.

**Keywords:** Base erosion, profit shifting, BEPS, competitiveness
Boosting Hong Kong’s Competitiveness in the BEPS Era

Introduction

In the Group of Twenty (G20) leaders’ meeting in June 2012, the finance ministers of the participating nations commissioned the Organization for Economic Co-operation and Development (OECD) to conduct a study and report on Base Erosion and Profit Shifting (BEPS). In July 2013, OECD and G20 countries adopted a 15-point Action Plan to address BEPS\(^1\). After a 2-year consultation period, the OECD presented the final package of anti-BEPS measures addressing all of the 15-point Action Plan in October 2015\(^2\).

The OECD/G20 BEPS Action Plan project makes significant changes to the global taxation environment. Many tax jurisdictions have introduced new initiatives to enhance tax transparency and combat cross-border tax evasion. Hong Kong has joined the OECD/G20 BEPS Action Plan project in June 2016 as an associate and is committed to cooperate with the international community to combat BEPS. On 26 October 2016, the Hong Kong Financial Services and The Treasury Bureau issued a consultation paper on proposed measures to counter BEPS. The

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2 On 16 September 2014, the OECD released the first set of reports and recommendations addressing 7 of the actions in the Base Erosion and Profit Shifting (BEPS) Action Plan. Available at: [http://www.oecd.org/tax/beps-2014-deliverables.htm](http://www.oecd.org/tax/beps-2014-deliverables.htm). On 5 October 2015, the OECD released the final package of measures addressing the remaining 8 of the actions in the BEPS Action Plan. This package was presented by OECD Secretary-General Angel Gurría to G20 Finance Ministers at their 8 October 2015 meeting in Lima, Peru and subsequently presented to G20 Leaders at their summit in Antalya, Turkey on 15-16 November 2015. Available at: [http://www.oecd.org/tax/oecd-presents-outputs-of-oecd-g20-beps-project-for-discussion-at-g20-finance-ministers-meeting.htm](http://www.oecd.org/tax/oecd-presents-outputs-of-oecd-g20-beps-project-for-discussion-at-g20-finance-ministers-meeting.htm).

All 15 actions are organized around the following three key pillars: coherence of corporate tax at the international level, realignment of taxation and substance, and transparency, certainty and predictability.
consultation paper sets out the Hong Kong government’s policy intent and priorities for the implementation of the anti-BEPS package.

While Hong Kong will cooperate with the international community to combat BEPS, Hong Kong needs to introduce tax and financial concessions as well as other policy support measures which are conductive to boosting its long-term competitiveness. Recently, Hong Kong introduced a set of tax and non-tax measures so as to elevate its competitive position. These measures include: (1) extending the profits tax exemption for offshore funds to private equity (PE) funds on 17 July 2015, (2) enacting a concessionary tax regime for qualifying corporate treasury centers on 3 June 2016, and (3) launching the Shenzhen-Hong Kong Stock Connect on 5 December 2016.

Using a legal research methodology, this study examines these new measures and evaluates their impacts on the international competitiveness of Hong Kong in the midst of anti-BEPS. The paper is organized as follows. Firstly, it outlines the responses of Hong Kong to the OECD/G20 BEPS Action Plan project. Secondly, the paper discusses the position of Hong Kong government in improving the long-term competitiveness in Hong Kong during the global anti-BEPS environment. Thirdly, it analyses the recent tax and non-tax measures and evaluates their impacts on Hong Kong’s international competitiveness. Finally, the paper concludes with implications.

Pragmatic Approach in Implementing the anti-BEPS Package

On 26 October 2016, the Hong Kong government launched a public consultation on implementing measures to counter BEPS in Hong Kong. The consultation paper focuses on the 4 OECD minimum standards\(^3\) and the related responses for Hong Kong to comply with the international standards in combating BEPS.

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\(^3\) The four minimum standards under BEPS Actions 5, 6, 13 and 14 as identified by the OECD include countering harmful tax practices, preventing treaty abuse, imposing country-by-country reporting requirement and improving cross-border resolution mechanisms. See Hong Kong Government (2016), *Consultation Paper on Measures to*
Table 1 indicates that Hong Kong has set priority on the 4 minimum standards as well as measures of direct relevance to their implementation. Hong Kong adopts a pragmatic strategy to counter BEPS\(^4\). It will put in place the necessary legislative framework for a transfer pricing regulatory regime (Action 8-10), spontaneous exchange of information on certain tax rulings (Action 5), country-by-country reporting requirement (Action 13), cross-border dispute resolution mechanism (Action 14), and multilateral instrument (Action 15)\(^5\). The key features of the proposed transfer pricing regime in Hong Kong are shown in Table 2.

Although Hong Kong considers that there are no immediate action is required for the remaining OECD/G20 BEPS Action Plan items, it will keep abreast of the international developments and make responsive actions when needed\(^6\). It is a long and ongoing journey for Hong Kong to implement the OECD/G20 BEPS Action Plan and align the Hong Kong’s tax system with the latest international developments\(^7\). New tax laws and rules will be introduced and the existing ones will be amended during the anti-BEPS compliant journey. However, Hong Kong is committed to uphold a simple and low tax regime because it is a key competitive advantage

\(^4\) See Hong Kong Government (2016), p. 3.

\(^5\) Hong Kong will introduce the relevant amendment bill(s) into the Legislative Council in mid-2017. See Hong Kong Government (2016), p. 3.

\(^6\) See Hong Kong Government (2016), paragraph 2.7.

underpinning the Hong Kong’s success in the past. The next section highlights the importance of enhancing Hong Kong’s competitiveness in the BEPS-era.

**Need for Enhancement in Competitiveness**

Hong Kong has long been regarded as the most vibrant international financial center in Asia. Its strengths include having the largest offshore RMB market, broad capital and treasury markets, an extensive network of banks, a free flow of capital, a sound legal system, a favorable simple and low tax regime, an abundance of professional services and an open information flow.

The Hong Kong government has called for the importance of enhancing its competitiveness in order that Hong Kong can have a strong momentum in economic growth under the global business environment. A review of the 87-pages 2017 Policy Address delivered by the Chief Executive on 18 January 2017 indicates that the government is committed to improve Hong Kong’s competitiveness:

- “Facing competitors, Hong Kong must consider how to enhance its overall competitiveness, including tax and financial concessions, and other policy support measures …” (paragraph 56, emphasis added).

- “… priority will be given to (overseas study) programmes conducive to boosting Hong Kong’s long-term competitiveness, in particular disciplines related to innovation and technology.” (paragraph 215, emphasis added).

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Echoing on the Policy Address, the Financial Secretary repeatedly emphasized the importance of Hong Kong’s competitiveness in the 72-pages 2017-18 Budget\(^\text{10}\) on 22 February 2017:

- “We should … enhance *competitiveness*, so that our economy and society can develop in a sustained manner …” (paragraph 25, emphasis added).

- “… a sound and progressive fiscal policy to … enhance our *competitiveness*” (paragraph 47, emphasis added).

- “… to examine the international *competitiveness* of our tax regime … to ensure that Hong Kong remains *competitive* and can create wealth.” (paragraph 54, emphasis added).

- “It is therefore of utmost importance to consolidate and enhance the *competitiveness* of our pillar industries.” (paragraph 69, emphasis added).

- “We need to examine ways to … elevate the position and *competitiveness* of Hong Kong as an international financial center.” (paragraph 94, emphasis added).

Hong Kong is facing the stiff competition from other economies. The above passages indicate that Hong Kong needs measures conducive to consolidate and enhance the Hong Kong’s overall competitiveness. The next section discusses the measures which are recently introduced and evaluates their impacts on boosting Hong Kong’s international competitiveness.

**Recent Measures in the anti-BEPS Era**

Recently, Hong Kong introduced a number of tax and non-tax measures. The tax measures include: (1) extending the profits tax exemption for offshore funds to PE funds on 17 July 2015 and (2) enacting a new legislation on corporate treasury centers on 3 June 2016. The non-tax measures are the Shanghai – Hong Kong Stock Connect (SH-HK Stock Connect) and the

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Shenzhen – Hong Kong Stock Connect (SZ-HK Stock Connect) which have been launched on 17 November 2014 and 5 December 2016 respectively.

1. Profits Tax Exemption for Funds

Hong Kong provides profits tax exemptions for certain funds in order to promote the asset management industry\(^\text{11}\). Figure 1 shows the existing profits tax implications for funds. 

Insert Figure 1 Here

Profits tax exemption are available to funds which are authorized by the Securities and Futures Commission (SFC) under the Securities and Futures Ordinance (SFO) as well as funds, though not authorized by the SFC, which are widely held and supervised by overseas regulatory authority\(^\text{12}\). The profits tax exemption for funds was extended by the Revenue (Profits Tax Exemption for Offshore Funds) Ordinance which was enacted in March 2006 (Offshore Funds Law). For non-SFC authorized widely held funds which are not supervised by overseas

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\(^{11}\) The Securities and Futures (Amendment) Ordinance 2016 gazetted on 10 June 2016 introduces the legal, regulatory and tax framework for an open-ended fund company (OFC) regime in Hong Kong. An OFC will be an alternative investment fund vehicle for funds domiciled in Hong Kong. The OFC regime is another measure to enhance Hong Kong’s asset management industry. However, the effective date of the OFC regime has yet to be appointed. Hence, this paper does not cover the OFC regime.

\(^{12}\) Section 26A(1A), Inland Revenue Ordinance (IRO). The profits tax exemption under section 26A(1A) is applicable to funds which are authorized or regulated by the Securities and Futures Commission (SFC) under the Securities and Futures Ordinance (SFO). Examples are authorized unit trusts and authorized mutual funds. The profits tax exemption under section 26A(1A) is also applicable to funds which are established outside Hong Kong if they are bona fide widely held and comply with the requirements of a supervisory authority within an acceptable regulatory regime. Examples are hedge funds which are supervised by overseas regulatory authority. The Inland Revenue Department (IRD) interprets “bona fide widely held” to mean there are at least 50 investors in the fund and there are at least 21 investors who are entitled to 75% or more of the income or property of the fund, or it is clear from the constitutive documents that the fund was established with a view to wide public participation and genuine efforts are taken to achieve that objective: Departmental Interpretation and Practice Notes No (DIPN) 20 (Mutual Funds, Unit Trust and Similar Investment Schemes), paragraphs 10-11. This interpretation is consistently applied by the IRD in other DIPNs. See DIPN 43 (Profits Tax Exemption for Offshore Funds), paragraphs 62-63 (note 27 below). Also see DIPN 51 (Profits Tax Exemption for Offshore Private Equity Funds), paragraphs 68-69 (note 49 below).
regulatory authority, if they are offshore funds, they may qualify for profits tax exemption if certain conditions are satisfied. Otherwise, these non-SFC authorized, widely held, non-supervised offshore funds may be subject to profits tax. For non-SFC authorized widely held funds which are not supervised by overseas regulatory authority, if they are local funds, they may be chargeable to profits tax. The Offshore Funds Law has 2 key elements: exemption provisions and deeming provisions. The exemption provisions are for non-resident persons only. The deeming provisions are to prevent abuse, or round-tripping, by resident investors disguised as non-resident persons to take advantage of the exemption provisions.

The exemption provisions provide profits tax exemption in respect of a person’s Hong Kong sourced profits if all of the following conditions are satisfied: (1) the person is a non-resident of Hong Kong, (2) the person carries on specified transactions and incidental transactions, (3)...

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13 Offshore funds, for the purpose of profits tax exemption for funds, refer to non-resident individuals and entities (including corporations, partnerships or trustees of trust estates): DIPN 43, paragraph 1.

14 Examples are offshore hedged funds which are not supervised by overseas regulatory authority.

15 Section 20AC, IRO. The exemption provisions are applicable from year of assessment 1996/97.

16 Section 20AE, IRO. The deeming provisions are applicable from year of assessment 2006/07.

17 DIPN 43, paragraph 43.

18 A non-resident person is a person who is not a resident person: section 20AB(3), IRO. Resident individual is one who ordinarily resides in Hong Kong, or stays in Hong Kong for more than 180 days in a year of assessment or more than 300 days in 2 consecutive years of assessment: section 20AB(2)(a), IRO. Resident entity (including corporation, partnership and trustee of trust estate) is one whose central management and control (CMC) is exercised in Hong Kong in that year of assessment: section 20AB(2)(b)-(d), IRO. The CMC refers to the highest level of control of the business of an entity and it is a question of fact and reality: DIPN 43, paragraph 14 and 16. It is noted that the IRD applies consistent interpretations on CMC on various DIPNs (note 57 below).

19 The term of “specified transactions” include transactions in securities, transactions in futures, transactions in foreign exchange contracts, transactions in foreign currencies, transactions in exchange-traded commodities and making of certain deposits other than money lending: Schedule 16 (Part 1), IRO. It is noted that the definition of securities under the 2006 Offshore Funds Law does not include securities issued by an excepted private company and issued by a special purpose vehicle (note 34 below).

20 The term of “incidental transaction” is not defined and will be accorded its common meaning. Typical incidental transactions include custody of securities and receipts of interest or dividend on securities acquired through the specified transactions: DIPN 43, paragraph 37.
the person does not carry on any trade or business in Hong Kong other than the specified transactions and incidental transactions\(^\text{21}\), and (4) the specified transactions are carried out through or arranged by specified persons\(^\text{22}\). An offshore fund will qualify for the exemption even if it carries out incidental transactions (which are subject to a 5% threshold that the trading receipts from incidental transactions do not exceed 5% of the total trading receipts) in the relevant year of assessment\(^\text{23}\). If the 5% threshold is not exceeded, the trading profits from the incidental transactions and the trading profits derived from the specified transactions will be exempted. If the 5% threshold is exceeded, the whole trading profits (if sourced in Hong Kong) from the incidental transactions will be chargeable to profits tax but the trading profits from the specified transactions will remain fully exempt\(^\text{24}\). Figure 2 summaries the profits tax implications of various transactions which are carried out by offshore funds.

**Insert Figure 2 Here**

On the other hand, the deeming provisions provide that a resident investor is chargeable to profits tax on its attributable income from the tax-exempt offshore fund on a daily basis\(^\text{25}\) if the following conditions are met: (1) the resident investor’s (including associates\(^\text{26}\)) beneficial interest (direct or indirect) in the tax-exempt offshore fund is 30% or more, or (2) the resident investor has beneficial interest (direct or indirect) in the tax-exempt offshore fund and the resident investor and the offshore fund are associates (see Figure 5 below for illustration of the

\(^{21}\) DIPN 43 does not provide clarifications as to the meaning of “other trade or business”. A practical problem is the distinction between what activities will be considered as “incidental” and what activities will be considered as “other trade or business”.

\(^{22}\) A specified person normally is a corporation licensed or an authorized financial institution registered under the SFO for carrying on a business in any regulated activity as defined by Part 1 of Schedule 5 to the SFO: section 20AC(6), IRO and DIPN 43, paragraph 39.

\(^{23}\) Section 20AC(4), IRO.

\(^{24}\) DIPN 43, paragraph 36.

\(^{25}\) Schedule 15 of IRO provides a formula to compute the assessable profits of the resident investor.

\(^{26}\) The term of “associates” is widely defined and includes relatives, partnership relationships and corporations under common control: section 20AC(6), IRO.
deeming provisions). However, the deeming provisions do not apply to the resident investor if the Commissioner of Inland Revenue (CIR) is satisfied that the beneficial interests of the offshore fund are bona fide widely held by the investors\(^{27}\). Figure 3 shows the application of the deeming provisions in the case of non-associated offshore fund and that of associated offshore fund.

**Insert Figure 3 Here**

Offshore PE funds cannot take advantage of the profits tax exemption under the 2006 Offshore Funds Law. The main reasons are that the then definition of “specified transactions” does not include private companies (but transactions in private companies are common in PE funds) and the requirement of “specified persons” in carrying out the specified transactions (but many PE fund transactions can be conducted by unlicensed managers)\(^{28}\). The profits tax exemption for funds was extended to offshore PE fund by the Inland Revenue (Amendment) (No. 2) Ordinance 2015 (Extended Offshore Funds Law)\(^{29}\). Offshore PE funds, which are non-SFC authorized fund\(^{30}\) and almost always closed-ended vehicles\(^{31}\), carrying out a specified transaction would qualify for profits tax exemption in respect of profits from that transaction if (1) the specified transaction has been carried out through or arranged by a specified person, or (2) the fund

\(^{27}\) Section 20AE(8), IRO. The IRD interprets “bona fide widely held” to mean there are at least 50 investors in the fund and there are at least 21 investors who are entitled to 75% or more of the income or property of the fund, or it is clear from the constitutive documents that the fund was established with a view to wide public participation and genuine efforts are taken to achieve that objective: DIPN 43 (Profits Tax Exemption for Offshore Funds), paragraphs 62-63.


\(^{29}\) The Extended Offshore Funds Law was enacted on 17 July 2015 and is effective from year of assessment 2015/16.

\(^{30}\) Private equity (PE) funds typically invest in private companies: DIPN 51, paragraph 3.

\(^{31}\) DIPN 51, paragraph 2.
conducting the specified transaction is a qualifying fund. Table 3 compares the 2006 Offshore Funds Law and the 2015 Extended Offshore Funds Law.

Insert Table 3 Here

There are four key elements in the Extended Offshore Funds Law. The first one is that specified transactions now include transactions in securities of an special purpose vehicle (SPV) or an excepted private company (EPC). An EPC is a private company incorporated outside Hong Kong and at all times within the 3 years prior to the transaction in securities of the SPV or EPC taking place:

- The EPC did not carry on any business through or from a permanent establishment (PE) in Hong Kong.

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32 Section 20AC(1) and (2), IRO. PE funds are typically collective investment schemes, with managers which may or may not be SFC licensed or registered. The concept of qualifying fund has taken into account the common practices in the PE fund industry in order to relax the profits tax exemption which was previously applied to specified transactions carried out through a specified person (being corporations and authorized financial institutions licensed or registered under the SFO). See PricewaterhouseCoopers (2015a). “Proposal to Extend Hong Kong Offshore Fund Exemption Regime”. January, p. 2. Available at: http://www.pwchk.com/en/private-equity/pe-tax-news-jan2015.pdf.

33 An special purpose vehicle (SPV) is a purpose-built structuring tool of PE funds: DIPN 51, paragraph 47.

34 Schedule 16 (Part 2), IRO. Securities include shares and other securities such as debentures and notes. It is noted that transactions in securities of an SPV or an excepted private company (EPC) are not treated as specified transactions under the 2006 Offshore Funds Law.

35 Private company is defined to mean a company incorporated in or outside Hong Kong that is not allowed to issue any invitation to the public to subscribe for any shares or debentures of the company: section 20ACA(2), IRO. Also, the terms of company, corporation and enterprise are used interchangeably in this article.

36 The 3-year time frame counts backward from the date of disposal of securities of or issued by the SPV or EPC: DIPN 51, paragraph 19.

37 Permanent establishment includes a fixed place of business and certain agents but excludes auxiliary activities, such as a buying office and facilities for storage, display or delivery of goods, etc.: section 20ACB, IRO.
• The aggregate value of the EPC’s (direct or indirect) holding of the equity interests in one or more private companies carrying on any business through or from a PE in Hong Kong did not exceed 10% of the EPC’s own assets, and

• The aggregate value of the EPC’s direct holding of immovable property in Hong Kong and its (direct or indirect) holding of the equity interests in one or more private companies with direct or indirect holding of immovable property in Hong Kong did not exceed 10% of the value of the EPC’s own assets\(^{38}\).

Figure 4 shows the application of the 10% safe harbor rule. Company A satisfies the 10% safe harbor rule and is an EPC, but Company B does not satisfy the 10% safe harbor rule and is therefore not an EPC.

**Insert Figure 4 Here**

The second key element in the Extended Offshore Funds Law is that a qualifying fund can also enjoy profits tax exemption. An offshore PE fund, which is a bona fide fund but is not managed by persons licensed or registered by the SFC, is a qualifying fund when it satisfies the following conditions: (1) the number of investors (excluding the originator and its associates\(^{39}\)) exceeds 4, (2) the capital commitments made by the investors exceed 90% of the aggregate capital commitments, and (3) the portion of the net proceeds to be received by the originator and its

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\(^{38}\) Section 20ACA(2), IRO. In calculating the value of the holding of the equity interests, the market value (not the par value or nominal value) of the capital is used. In calculating the value of the total assets of a company, debts of the company including liabilities secured by mortgages on the relevant immovable property are not deducted. Hence, the gross amount of the asset values are used in the 10% safe harbor rules: DIPN 51, paragraph 23. When applying the 10% safe harbor rules, the IRD will examine the audited financial statements of the 3 most recent years as well as management accounts up to the date of the transaction in securities of the SPV or EPC: DIPN 51, paragraph 25. Although the IRD approach is practical, it effectively extends the 3 year measurement period in most cases.

\(^{39}\) The term of “originator” means a person who directly or indirectly originates or sponsors the funds and has the power to make investment decisions on behalf of the fund: section 20AC(6), IRO. Also, the term of “associates” is widely defined (note 26 above). In the context of a limited partnership structure, generally the originator and its associates are the general partners and the investors are the limited partners.
associates does not exceed 30% of the net proceeds (after deducting the cumulative capital contributions made by the investors, the originator and its associates)\(^40\).

The third key element in the Extended Offshore Funds Law is that an SPV will be exempt from payment of profits tax in respect of gain on disposal of an EPC or an interposed SPV\(^41\). The SPV 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 an offshore PE fund and is established solely for the purpose of holding, directly or indirectly, and administrating the EPC\(^42\). Hence, the SPV cannot carry on any trade or activities except for the purpose of holding and administrating the EPC\(^43\). Also, it is not itself an EPC\(^44\).

The last key element in the Extended Offshore Funds Law is that there are 2 deeming provisions to prevent abuse or round-tripping by resident investors, disguised as non-resident investors, to take advantage of the profits tax exemption for offshore PE funds\(^45\). The first deeming provisions

\(^{40}\) Section 20AC(6), IRO.

\(^{41}\) Section 20ACA(1), IRO.

\(^{42}\) The words “holding” and “administrating” are not defined. They shall be interpreted based on their literal meaning. It is noted that the holding and administrating of an EPC will not be interpreted as the management of the business of the EPC. Hence, the maintenance and administration of the business of the EPC are not allowed. The activities of the SPV are restricted to: the review of financial statements of EPC normally made available to shareholders or investors, attending the shareholders’ meetings of EPC, opening bank accounts for collection of dividends or investment receipts and appointing company secretary and auditor: DIPN 51, paragraph 49. Clearly, the permitted activities to be performed by the SPV are very restrictive and are less than what would ordinarily be required by an investment holding SPV. In addition, the place of residence of the SPV generally follows that of the offshore PE fund, regardless that the SPV might be incorporated or registered in Hong Kong. Hence, the Hong Kong SPVs may not qualify as Hong Kong tax residents and hence obtain tax residency certificates (TRCs) from the IRD to claim for tax treaty benefits because the IRD will require the SPVs to have substantial business activities (e.g., the SPV has a permanent office or employs staff in Hong Kong to hold and administer its investment in EPCs) for issuance of TRCs: DIPN 51, paragraphs 80-82.

\(^{43}\) The SPV is expected to only derive passive dividend income from EPCs: DIPN 51, paragraph 48.

\(^{44}\) Section 20ACA(2), IRO.

\(^{45}\) DIPN 51, paragraph 56.
follow that of the 2006 Offshore Funds Law: when a resident investor, alone or jointly with its associates has direct or indirect beneficial interest of 30% or more in a tax-exempt offshore PE fund, or any percentage if the offshore PE fund is the resident investor’s associate, the resident investor is deemed to have derived assessable profits in respect of the profits earned by the fund from the specified transactions and incidental transactions carried out in Hong Kong.\(^{46}\)

The second deeming provisions are new laws which prevent bookings of profits in SPVs without distributing to the offshore PE funds\(^{47}\): when the offshore PE fund has a beneficial interest in an SPV that is exempt from the payment of tax in respect of its assessable profits from disposal of an EPC or an interposed SPV, the resident investor is deemed to have derived assessable profits in respect of the profits earned by the SPV\(^{48}\). However, these deeming provisions are not applicable to the resident investor if the CIR is satisfied that beneficial interests in an offshore fund are bona fide widely held by investors\(^{49}\).

The 2006 Offshore Funds Law has put Hong Kong in a relatively disadvantaged position to attract PE fund business\(^{50}\). The 2015 Extended Offshore Funds Law, which now include

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\(^{46}\) Section 20AE, IRO. Schedule 15 of IRO provides a formula to compute the assessable profits of the resident investor.

\(^{47}\) DIPN 51, paragraph 56.

\(^{48}\) Section 20AF, IRO. They are applicable from year of assessment 2015/16. Schedule 15A of IRO provides a formula to compute the assessable profits of the resident investor.

\(^{49}\) Section 20AF(7), IRO. The IRD interprets “bona fide widely held” to mean there are at least 50 investors in the fund and there are at least 21 investors who are entitled to 75% or more of the income or property of the fund, or it is clear from the constitutive documents that the fund was established with a view to wide public participation and genuine efforts are taken to achieve that objective. Since a typical PE fund is unlikely to have 50 investors or more, the “50 or more investors” and “at least 21 investors holding 75% or more of the fund” criteria for determining what constitutes a bona fide widely held are practically of limited assistance for PE fund. In fact, the IRD recognizes that PE funds by their nature are unlikely to be bona fide widely: DIPN 51, paragraphs 68-69.

transactions in shares and other securities issued by certain overseas private entity (i.e., EPCs) or issued by SPVs, allows offshore PE funds managed by SFC licensed managers as well as unlicensed managers to enjoy the profits tax exemption. It represents a positive step to enhance Hong Kong’s position as an attractive and competitive international asset management center. Although the Inland Revenue Department (IRD)’s clarification in DIPN 51 of how it will interpret and apply the extended regime is welcome, there are some practical concerns for the industry players. It is difficult for the offshore PE fund to monitor the 10% safe harbor rule since the fund often acquires less than 100% stake in an EPC and does not have sufficient influence over the activities and subsequent choice of investments by the EPC concerned. Also, it is difficult for the offshore PE fund to ensure the 10% safe harbor rule is met throughout the whole 3-year look-back period because asset valuations can fluctuate over time and the timing of disposals are hard to predict. Given that the IRD interprets an SPV as an investment vehicle, the permitted scope of its activities is very restrictive. This, together with the IRD’s interpretation that the place of residence of the SPV generally follows that of the offshore PE fund, it is hard for a Hong Kong SPV to obtain Hong Kong tax resident certificate for claiming tax treaty benefits. Although an SPV should be established solely for the purpose of holding and administrating the EPC, it is unclear whether, if not the SPV concerned, the offshore PE fund itself can be involved in the management and maintenance of the business of an EPC. Furthermore, the extent of the tainting effect, in particular whether one non-qualifying transaction undertaken by an SPV would taint other qualifying transactions undertaken by other SPVs of an offshore PE fund will require more clarifications. With further guidance from the


52 Chan and Wong (2016) commented that some of the IRD’s comments in DIPN 51 are likely to create considerable uncertainty within the PE industry which in turn may adversely affect the objective of the extended offshore funds law to attract more PE fund managers to perform more fund management activities in Hong Kong.

53 Ernst & Young (2016). “New Practice Note Explains how IRD will Interpret the New Law Exempting PE Funds from Tax”. June, pp. 1-5. Available at: http://www.ey.com/publication/vwlUAssets/EY-hong-kong-tax-alert-8-jun-2016-fs/%24FILE/EY-hk-tax-alert-issue-12-fs.pdf. The IRD mentions that a non-qualifying transaction (i.e., not a specified transaction and not an incidental transaction) undertaken by an offshore PE fund will taint all other qualifying transactions by that fund: DIPN 51, paragraph 54. It is unclear whether the tainting effect also applies to the situation where the relevant transaction is undertaken by an SPV of an offshore PE fund.
IRD, the extended fund regime will reinforce the role of Hong Kong as the region’s full-service asset management hub by attracting more offshore fund managers to set up or expand their business in Hong Kong and by creating more demand for asset management, investment and advisory services in Hong Kong.

2. **Corporate Treasury Center Regime**

On 3 June 2016, Hong Kong enacted a piece of tax legislation to provide a conducive environment for attracting multinational enterprises (MNEs), including Mainland China MNEs\(^{54}\), to establish corporate treasury centers (CTCs) in Hong Kong to provide treasury services for their group companies. A qualifying CTC can make an election in writing to have its qualifying profits taxed at the 8.25% concessionary tax rate (i.e., 50% of the normal profits tax rate of 16.5%)\(^{55}\). Such election, once made, is irrevocable so long as the corporation remains as a qualifying CTC\(^{56}\).

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\(^{54}\) The Corporate Treasury Center (CTC) regime will facilitate the drive of mainland Chinese multinational enterprises (MNEs) to go global under the Mainland China’s “Going Out” and “One Belt, One Road” initiatives. The “Going Out” initiative is an important strategy first put forward by the Chinese government in 2000 to encourage mainland Chinese MNEs to invest overseas. See Financial Services Development Council (2015). “Chinese Enterprises ‘Going Global’: Opportunities and Hong Kong’s Policy Responses”. April, paragraph 1. Available at: [http://www.fsdc.org.hk/sites/default/files/Chinese%20Enterprises%20Going%20Global%20%28final%29.pdf](http://www.fsdc.org.hk/sites/default/files/Chinese%20Enterprises%20Going%20Global%20%28final%29.pdf). The “One Belt, One Road” initiative is a development strategy started by the Chinese government in 2013. It refers to the New Silk Road Economic Belt, which will link China with Europe through Central and Western Asia, and the 21st Century Maritime Silk Road, which will connect China with Southeast Asian countries, Africa and Europe. See CaixinOnline (2014). “One Belt, One Road”. 10 December. Available at: [http://english.caixin.com/2014-12-10/100761304.html](http://english.caixin.com/2014-12-10/100761304.html).

\(^{55}\) Section 14D(1) and 14D(5)(b), IRO.

\(^{56}\) Section 14D(6), IRO. When a corporation elected and became a qualifying CTC but fails to meet the qualifying conditions in a given year of assessment, it will be denied the 8.25% concessionary profits tax rate for that year of assessment and subsequent years of assessment: section 14D(7), IRO. The corporation will have to make another election when it becomes a qualifying CTC again and would like to enjoy the 8.25% concessionary profits tax rate. See PricewaterhouseCoopers (2016b). “Hong Kong is Now in a Competitive Position for Setting up a Regional Corporate Treasury Center”. May, p. 3. Available at: [http://www.pwchk.com/webmedia/doc/635999413097675115_hktax_news_may2016_5.pdf](http://www.pwchk.com/webmedia/doc/635999413097675115_hktax_news_may2016_5.pdf).
The concessionary profits tax rate is not a harmful tax practice because there are two “Hong Kong business substance” requirements for a qualifying CTC. First, the central management and control of the corporation concerned is exercised in Hong Kong. Second, the activities that produce the qualifying profits in that year are carried out in Hong Kong by the corporation itself or arranged by the corporation to be carried out in Hong Kong.

A qualifying CTC is a standalone corporate entity, other than a financial institution, which is dedicated to the conduct one or more of the following corporate treasury activities:

- Carrying on an intra-group financing business,

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57 The CMC test is a question of fact and reality. It refers to the highest level of control. In general, if the CMC of a company is exercised by the directors in board meetings, the location of CMC is where those meetings are held. However, the place of board meetings may not be conclusive. It is significant only when those meetings constitute the medium through which CMC is exercised: DIPN 52 (Taxation of Corporate Treasury Activity), paragraphs 50-54. Also, the CMC requirement will support the CTC to qualify as Hong Kong tax resident and hence obtain TRC from the IRD for the purpose of claiming tax treaty benefits. See PricewaterhouseCoopers (2015c). “The Draft Tax Law on Corporate Treasury Center in Hong Kong”. December, p. 3. Available at: http://pwchk.com/webmedia/doc/635857025856831628_hktax_news_dec2015_12.pdf.

58 Section 14D(5)(a), IRO.

59 Section 14D(9), IRO.

60 Section 14D(2)(a), 14D(3) and 14C(1), IRO.

61 The term of “intra-group financing business” in the concessionary tax regime has the same definition as the interest deduction rule. It refers to the business of the borrowing of money from and lending of money to its associated corporations: section 14C(1), IRO. It does not include isolated borrowing and lending transactions. Whether a corporation is carrying on an intra-group financing business is a question of fact and factors such as the frequency, repetitiveness, amount of borrowing from and lending to associated corporations, commerciality of interest rates and payment conditions will be considered: DIPN 52, paragraph 9. Generally, the CIR would accept that a corporation is carrying on an intra-group financing business if: (i) the corporation has not less than 4 borrowing or lending transactions each month, (ii) each borrowing or lending transactions exceeds HK$250,000, and (iii) borrowing or lending transactions are with not less than 4 associated corporations in the relevant basis period: DIPN 52, paragraph 10. The intra-group financing business can rely on funding through various sources (e.g., bank finance or equity): DIPN 52, paragraph 10. Hence, a Hong Kong corporation may still qualify as carrying on an intra-group financing business even the lending to its non-Hong Kong associated corporation is funded by bank borrowings (when there is a commercial need to borrow from banks) or dividends received (when an investing holding company with surplus funds from dividends received lends those surplus funds to its group companies). See PricewaterhouseCoopers (2016c). “The IRD Clarifies the Operation of the Tax Regime on Qualifying Corporate Treasury Centers”. September, p. 3. Available at: http://www.pwchk.com/en/hk-tax-news/hktax-news-sep2016-9.pdf. However, it is doubtful if a wholly bank-financed or equity-financed Hong Kong corporation can be accepted as carrying on an intra-group financing business. See Deloitte (2016a). “Hong Kong Tax News: The Inland Revenue
• Providing corporate treasury services, or
• Entering into corporate treasury transactions.

Corporate treasury services include certain specific services provided by a qualifying CTC to an associated corporation\(^{62}\). Similarly, corporate treasury transactions include certain specified transactions entered into by a qualifying CTC on its own account which are related to the business of an associated corporation\(^{63}\).

In determining whether other activities are performed, only activities that generate income to the corporation will be taken into account\(^{64}\). A corporation not dedicated solely to one or more of the above-mentioned three corporate treasury activities may also be regarded as a qualifying CTC if it satisfies one of the safe harbor rules:

• The 1-year safe harbor: both the aggregate amount of the corporate treasury profits (CTP) and the aggregate value of the corporate treasury assets (CTA) for the year of assessment concerned are not less than 75% of the total amounts of the profits and value of the assets of

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\(^{62}\) Section 14C(1) and (3), section 1(1) of Schedule 17B, IRO. It is noted that corporate treasury services do not include re-invoicing services: DIPN 52, paragraph 67.

\(^{63}\) Section 14C(1) and (4), section 2(1) of Schedule 17B, IRO. It is noted that corporate treasury transactions do not include re-invoicing transactions: DIPN 52, paragraph 67.

\(^{64}\) Section 14D(4), IRO. A Hong Kong corporation can qualify as a CTC when it performs the prescribed corporate treasury activities and other corporate supporting functions for its group companies so long as the Hong Kong corporation does not recharge the group companies on the other corporate supporting functions performed. However, such a zero-recharge arrangement may not be acceptable by the IRD from a TP perspective. See PricewaterhouseCoopers (2015c), p. 2. The IRD also explains that expense transactions (e.g., borrowing money from financial institutions, taking a lease in respect of the business premise for carrying out corporate treasury activities) would not preclude the Hong Kong corporation from being a qualifying CTC since the corporation would only incur expenses (e.g., interest or rental expenses) in these transactions: DIPN 52, paragraph 49.
the CTC concerned\(^{65}\), or

- The multiple-year safe harbor: both the average amount of the corporate treasury profits (CTP) and the average value of the corporate treasury assets (CTA) within the specified years\(^{66}\) are not less than 75% of the average amounts of the profits and value of the assets of the CTC concerned\(^{67}\).

Finally, a corporation, which does not dedicate solely to one or more of the above-mentioned three corporate treasury activities and does not satisfy the safe harbor rules, may also be regarded as a qualifying CTC if it has obtained a determination from the CIR.\(^{68}\)

The qualifying profits of a qualifying CTC are profits which are generated from the following transactions\(^{69}\):

- Money lent in the ordinary course of the qualifying CTC’s intra-group financing business to a non-Hong Kong associated corporation,

- A corporate treasury service provided by the qualifying CTC to a non-Hong Kong associated corporation.

\(^{65}\) Section 14E(1)(a), 14E(2), 14E(5)-(6) and Part 3 of Schedule 17B, IRO. Equity investment in associated corporations and dividends will be excluded in the formulas for the calculation of the CTA and CTP percentages: DIPN 52, paragraph 74. Hence, it is possible for a regional holding company which performs group treasury functions to become a qualifying CTC under the safe harbor rules. See PricewaterhouseCoopers (2016c), p. 2.

\(^{66}\) If the corporation carries on a trade, profession or business in Hong Kong for 2 or more consecutive years of assessment immediately before the year of assessment concerned, the specified years will be the year of assessment concerned and the preceding 2 years of assessment (i.e., the specified years equal to 3): section 14E(4)(b), IRO. If the corporation carries on a trade, profession or business in Hong Kong for less than 2 consecutive years of assessment immediately before the year of assessment concerned, the specified years will be the year of assessment concerned and the preceding 1 year of assessment (i.e., the specified years equal to 2): section 14E(4)(a), IRO.

\(^{67}\) Section 14E(1)(b), 14E(3), 14E(3), (7)-(8) and Part 3 of Schedule 17B, IRO. Equity investment in associated corporations and dividends will be excluded in the formulas for the calculation of the CTA and CTP percentages: DIPN 52, paragraph 74.

\(^{68}\) Section 14D(2)(c) and 14F, IRO.

\(^{69}\) Section 14C(1) and 14D(1)(a)-(c), IRO. To qualify for the concessionary profits tax rate, the sums paid to the CTC for the three types of qualifying transactions cannot be tax deductible by the payer in Hong Kong: section 14D(8), IRO.
corporation\textsuperscript{70}, and

- A corporate treasury transaction entered into by the qualifying CTC on its own account that is related to the business of a \textit{non-Hong Kong} associated corporation\textsuperscript{71}.

A \textit{non-Hong Kong} associated corporation is defined as an associated corporation which does not carry on any trade, profession or business in Hong Kong\textsuperscript{72}. The concessory profits tax rate (8.25\%) only applies to the qualifying CTC’s qualifying profits, which are profits derived by the qualifying CTC from transactions with \textit{non-Hong Kong} associated corporations. Such a “\textit{non-Hong Kong} associated corporation” requirement “is an anti-avoidance provision to prevent circumstances where the qualifying profits of a qualifying CTC are subject to taxation at the concessory tax rate whereas the corresponding payments are eligible for tax deduction at the normal rate by the (Hong Kong associated corporation) payers”\textsuperscript{73}.

Hong Kong has been playing an important role in facilitating both the inbound investments from overseas to Mainland China and outbound investments from Mainland China to overseas. It is a preferred investment springboard because it has a sound, efficient and stable financial and legal framework as well as a simple tax system. In addition, Hong Kong is a preferred “Going Out” platform for Mainland China MNEs when they decide to spread their footprints outside of

\textsuperscript{70} If a qualifying CTC enters into a corporate treasury service contract with a \textit{non-Hong Kong} associated corporation which in turn enters into a back-to-back service contract on the same terms with a Hong Kong associated corporation, the corporate treasury service, which is, in substance, provided by the qualifying CTC to a Hong Kong associated corporation, would not be regarded as a qualifying corporate treasury service. Similarly, if a qualifying CTC provides corporate treasury services indirectly to a \textit{non-Hong Kong} associated corporation through a Hong Kong associated corporation, then the corporate treasury service would not be regarded as a qualifying corporate treasury service in the absence of any contractual relationship between the qualifying CTC and the \textit{non-Hong Kong} associated corporation: DIPN 52, paragraph 83. It appears that the IRD takes the “substance over form” approach and see through the legal service contract between the qualifying CTC and the \textit{non-Hong Kong} associated corporation in order to tackle a back-to-back arrangement. See PricewaterhouseCoopers (2016c), p. 2.

\textsuperscript{71} For the purpose of qualifying profits, a qualifying CTC can enter a corporate treasury transaction with a Hong Kong entity (e.g., placing a deposit with a Hong Kong bank, investing in notes/bonds and other financial instruments issued by a Hong Kong entity) when it is related to the business of a \textit{non-HK} associated corporation. See PricewaterhouseCoopers (2015c), p. 2.

\textsuperscript{72} Section 14C(1), IRO.

\textsuperscript{73} See PricewaterhouseCoopers (2015c), p. 2.
Mainland China because Hong Kong is the largest offshore RMB center. In fact, about 58% of Mainland China’s outbound foreign direct investment has made through Hong Kong in recent years. Despite the keen competition from Singapore, the new CTC regime will put Hong Kong as a premier location for MNEs to set up or relocate their regional CTCs for expansion into the growing Mainland China market and for Mainland China MNEs to establish or relocate their regional CTCs for expansion into the developing economies under the Mainland China’s “One Belt, One Road” initiative. Also, the new CTC regime will contribute to the development of the headquarter economy in Hong Kong because MNEs usually set up the regional CTCs and regional headquarters in the same place for better business operations and management.

Overall, the new CTC regime can enhance Hong Kong’s status as an international financial center.

3. **Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect**

The Shanghai-Hong Kong (SH-HK) Stock Connect and the Shenzhen-Hong Kong (SZ-HK) Stock Connect are officially launched on 17 November 2014 and 5 December 2016 respectively. They are the pilot programmes for securities trading and clearing links to enable investors of Mainland China (Hong Kong) market to trade eligible securities listed in the Hong Kong (Mainland China) market. Prior to the launch of (SH-HK) Stock Connect and the SZ-HK Stock Connect, Mainland China investors are usually not able to invest in overseas stock markets

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directly\(^76\) and foreign investors are usually not able to access the Mainland China’s A-share market\(^77\).

The SH-HK Stock Connect and SZ-HK Stock Connect follow the same model and consist of the “southbound trading link” and “northbound trading link”. The former is open to the Mainland China institutional investors and high-worth individual investors\(^78\) to invest in certain shares listed in Hong Kong. The latter is for all Hong Kong and overseas investors, both institutional and individual, to access eligible A-shares listed in Shanghai or Shenzhen. Below is an analysis of the major Hong Kong tax and Mainland China tax issues for investors under these Stock-Connect programmes:

\[a. \quad \text{Hong Kong tax implications for Mainland China investors on southbound trading link}\]

In a typical southbound trading transaction, the Mainland China institutional investors will place their purchase/sale orders through a stock broker in Mainland China and are not required to carry out any activity in Hong Kong. The disposal gains are generally not regarded as trading receipts of the Mainland institutional investors or not from a trade or business carried out by them in Hong Kong. As such, the disposal gains derived the Mainland China institutional investors are generally not chargeable to Hong Kong profits tax\(^79\). Also, the dividend incomes received by the

\(^76\) However, Mainland China investors can access the overseas stock markets via the Qualified Domestic Institutional Investors (QDII) scheme.

\(^77\) However, foreign investors can access the Mainland China’s A-share market (i.e., shares in Mainland China companies that are incorporated in Mainland China and traded on the Shanghai/Shenzhen Stock Exchange in RMB) via the Qualified Foreign Institutional Investors (QFII) scheme and RMB Qualified Foreign Institutional Investors (RQFII) scheme.

\(^78\) Individuals with aggregate balance of not less than RMB500,000 in securities and cash accounts.

\(^79\) The scope of charge of Hong Kong profits tax requires all of the following 3 conditions to be satisfied: (a) a person carries on a trade, business or profession in Hong Kong, (b) profits arises from that trade, business or profession and (c) profits arising in or derived from Hong Kong. Also, profits from disposal of capital assets are excluded: section 14(1), IRO. Hence, the disposal gains derived by the Mainland China institutional investors from shares listed in Hong Kong are not chargeable to profits tax because they are non-trading in nature. Furthermore,
Mainland China institutional investors are specifically exempt from Hong Kong profits tax. Similarly, the disposal gains derived the Mainland China individual investors are generally not chargeable to Hong Kong profits tax. Also, the disposal gains and dividend incomes derived by the Mainland China individual investors are not chargeable to Hong Kong salaries tax due to the limited scope of charge. However, the southbound trading of Hong Kong stocks made by the Mainland China institutional and individual investors will attract Hong Kong stamp duty which is at the rate of 0.1% (payable by both the transferee and transferor) of the higher of consideration or market value of the stocks transferred. Table 4 (Panel A) summarizes the Hong Kong tax implications for Mainland China investors.

b. **Hong Kong tax implications for Hong Kong/overseas investors on northbound trading link**

In a typical northbound trading transaction, the Hong Kong/overseas institutional investors will place their purchase/sale orders through a stock broker in Hong Kong and are not required to carry out any activity in Mainland. The disposal gains are generally not regarded as trading receipts of the Hong Kong/overseas institutional investors or not sourced in Hong Kong. As such, the disposal gains derived the Hong Kong/overseas institutional investors are generally not chargeable to Hong Kong profits tax. Also, the dividend incomes received by the Hong Kong/overseas institutional investors are not chargeable to Hong Kong profits tax because they under the Fourth Protocol to the Arrangement between the Mainland China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (Mainland China-Hong Kong DTA), the taxing rights of the disposal gains derived by Mainland China residents from shares listed in Hong Kong is allocated to the Mainland China tax authority and the Hong Kong tax authority cannot impose tax on these gains: Article 13(7), Mainland China-Hong Kong DTA.

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80 Section 26(a), IRO.

81 The scope of charge of Hong Kong salaries tax imposes tax on: (a) income from Hong Kong and non-Hong Kong employment, (b) income from Hong Kong office or (c) income from Hong Kong pension: section 8(1) and section 8(1A), IRO. Hence, disposal gains from shares and dividend incomes are not chargeable to salaries tax.

82 Head 2, First Schedule, Stamp Duty Ordinance. There are 2 dutiable instruments for sale/purchase of Hong Kong shares: (1) contract notes – attracting 0.1% (payable by both the seller and buyer) of the higher of consideration or market value of shares transferred and (2) instrument of transfer – fixed duty of HK$5.

83 See note 79 above.
are generally regarded as non-Hong Kong source\textsuperscript{84}. Similarly, the disposal gains derived the Hong Kong/overseas individual investors are generally not chargeable to Hong Kong profits tax. Also, the disposal gains and dividend incomes derived by the Hong Kong/overseas individual investors are not chargeable to Hong Kong salaries tax due to the limited scope of charge\textsuperscript{85}. Table 4 (Panel B) summarizes the Hong Kong tax implications for Hong Kong/overseas investors.

\textbf{Insert Table 4 Here}

c. \textit{Mainland China tax implications for Mainland China investors on southbound trading link}\textsuperscript{86}

The disposal gains derived by the Mainland China institutional investors from the transfer of shares listed in Hong Kong are subject to Mainland China corporate income tax (CIT)\textsuperscript{87}, but are temporarily exempted from Mainland China value added tax (VAT)\textsuperscript{88}. The dividend incomes derived by the Mainland China institutional investors are generally subject to CIT\textsuperscript{89}. On the other hand, the disposal gains derived by the Mainland China individual investors from the transfer of

\textsuperscript{84} Dividend income paid out from the Mainland China A-share company with its underlying business and operation conducted outside Hong Kong will generally be regarded as non-Hong Kong sourced.

\textsuperscript{85} See note 81 above.

\textsuperscript{86} The Ministry of Finance, State Administration of Taxation and China Securities Regulatory Commission have joined issued Caishui [2014] No. 81 (Circular 81) on 31 October 2014 (available at: \url{http://www.chinatax.gov.cn/n810341/n810755/c1305421/content.html}) and Caishui [2016] No. 127 (Circular 127) on 5 November 2016 (available at: \url{http://szs.mof.gov.cn/zhengwuxinxi/zhengcefabu/201611/t20161130_2470191.html}) to clarify the tax treatments of investors investing through the Shanghai-Hong Kong Stock Connect and the Shenzhen-Hong Kong Stock Connect respectively. The tax policies in these 2 circulars are almost identical.

\textsuperscript{87} Article 1(2), Circular 81 and Article 1(2), Circular 127.

\textsuperscript{88} Article 3(3), Circular 81 and Article 3(3), Circular 127.

\textsuperscript{89} An exception is that dividends from H-share companies (i.e., shares in Mainland China companies that are incorporated in Mainland China and traded on the Hong Kong Stock Exchange in HK$) which the Mainland China institutional investors held for no less than 12 months will be exempted from Mainland China corporate income tax (CIT): Article 1(4)(1), Circular 81 and Article 1(4)(1), Circular 127. When CIT is payable on dividend received from eligible shares in Hong Kong market, the Mainland China institutional investors should make self-declaration and settle the tax payable: Article 1(4)(2), Circular 81 and Article 1(4)(2), Circular 127.
shares listed in Hong Kong are temporarily exempted from Mainland China individual income tax (IIT) for the period from 5 December 2016 to 4 December 2019\(^90\), and are temporarily exempted from VAT\(^91\). Also, the dividend incomes derived by the Mainland China individual investors are generally subject to IIT of 20% on withholding basis\(^92\). Table 5 (Panel A) summarizes the Mainland China tax implications for Mainland China investors.

\(d\). Mainland China tax implications for Hong Kong/overseas investors on northbound trading link

The disposal gains derived by the Hong Kong/overseas institutional and individual investors from the transfer of A-shares listed in Mainland China are temporarily exempt from CIT or IIT respectively\(^93\), and are temporarily exempted from VAT\(^94\). However, Mainland China stamp duty will be imposed on the seller of A-shares at the rate of 0.1% of the consideration\(^95\). Also, the dividend incomes derived by the Hong Kong/overseas institutional and individual investors are subject to CIT or IIT respectively of 10% on withholding basis\(^96\). Also, the northbound trading of A-shares made by the Hong Kong/overseas institutional and individual investors will attract

\(^{90}\) Article 1(1), Circular 81 and Article 1(1), Circular 127.

\(^{91}\) Article 3(2), Circular 81 and Article 3(2), Circular 127.

\(^{92}\) If the dividend-payer is a H-share company, the H-share company has to withhold Mainland China individual income tax (IIT) with respect to its dividend distribution to the Mainland China individual investors. If the dividend-payer is a non-H share company, the China Securities Depository and Clearing Corporation has to withhold IIT with respect to the dividend distribution to the Mainland China individual investors: Article 1(3), Circular 81 and Article 1(3), Circular 127.

\(^{93}\) Article 2(1), Circular 81 and Article 2(1), Circular 127. Furthermore, the taxing rights of the disposal gains derived by Hong Kong residents from shares listed in Mainland China is allocated to the Hong Kong tax authority and the Mainland China tax authority cannot impose tax on these gains: Article 13(7), Mainland China-Hong Kong DTA.

\(^{94}\) Article 3(1), Circular 81 and Article 3(1), Circular 127.

\(^{95}\) Article 4, Circular 81 and Article 4, Circular 127.

\(^{96}\) The A-share company distributing the dividend has the withholding obligation. If the overseas investor is entitled to a lower treaty rate, the investor can apply to the in-charge tax authority of the dividend-paying A-share company for a refund: Article 2(2), Circular 81 and Article 2(2), Circular 127.
Mainland China stamp duty which is at the rate of 0.1% (payable by the transferor) of the consideration. Table 5 (Panel B) summarizes the Mainland China tax implications for Hong Kong/overseas investors.

**Insert Table 5 Here**

In terms of market capitalization, the Shanghai Stock Exchange, Shenzhen Stock Exchange and Hong Kong Stock Exchange collectively constitute the second largest stock market in the world\(^\text{97}\). The SH-HK Stock Connect and SZ-HK Stock earmark the connection of the financial markets in Mainland China and Hong Kong. They represent cooperative efforts between the Mainland China and Hong Kong in widening capital pool between Shanghai, Shenzhen and Hong Kong\(^\text{98}\). Mainland China and Hong Kong will be mutually benefitted. The Mainland China’s A-share market will be broadened with Hong Kong/overseas investors. The Hong Kong’s strategic position will be strengthened with international investors accessing the Mainland China capital market and the Mainland China investors going out. In addition, the SH-HK Stock Connect and SZ-HK Stock Connect support the Mainland China to internationalize the RMB currency and enhance the role of Hong Kong as an international financial center\(^\text{99}\).

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Implications and Conclusion

The OECD final package of the 15-point Action Plan is not the end but only part of the journey in tackling BEPS. In the BEPS era, it is important that jurisdictions cooperate with each other and introduce domestic laws and regulations to implement the recommendations. Recently, Hong Kong has made rapid developments. The extension of the profits tax exemption to offshore PE funds is a positive step taken by the Hong Kong government to enhance Hong Kong as a competitive international asset management center. The new CTC regime provides a more tax-friendly environment for MNEs to set up their group treasury functions in Hong Kong. Also, the Shenzhen-Hong Kong Connect in December 2016 and the Shanghai-Hong Kong Connected in November 2014 strengthen Hong Kong’s strategic role as a platform for international investors to access the Mainland China capital markets and Mainland China investors to go aboard. These measures are conducive to Hong Kong’s economic growth and will put Hong Kong in a more competitive position as a premier regional asset management center and an international financial center. All in all, Hong Kong will play the role of super-connector between Mainland China and the rest of the world.
Table 1: Hong Kong Responses to the OECD’s Four Minimum Standards on BEPS

<table>
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<tr>
<th>OECD’s Four Minimum Standards on BEPS</th>
<th>Hong Kong Responses</th>
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| Action 5: Countering harmful tax practices and improving transparency in relation to rulings | • No specific action on preferential regimes is proposed.  
• To conduct spontaneous exchange of information on 6 categories of tax rulings (see note 1 below) with Comprehensive Double Tax Agreement (CDTA) or Tax Information Exchange Agreement (TIEA) partners on a bilateral basis. |
| Action 6: Preventing treaty abuse | • To modify CDTAs: Hong Kong is inclined to adopt the principal purposes test as the preferred anti-treaty abuse rule.  
• To be further supported by implementing Action 15 (Multilateral Instrument (MLI)): Hong Kong is prepared to sign the MLI in early 2017. |
| Action 13: Transfer pricing (TP) documentation and Country-by-Country (CbC) reporting | • To adopt the OECD’s three-tier TP documentation requirements (i.e., master file, local file and CbC report) (see notes 2-4 below).  
• To conduct automatic exchange of CbC reports with CDTA and TIEA partners on a bilateral basis: the current plan is for the relevant multinational enterprises to gather the information in 2018 and file their first CbC reports to the Inland Revenue Department in 2019.  
• To be further supported by implementing Actions |
<table>
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<tr>
<th>8-10: the introduction of TP regulatory regime (see Table 2) and enhancement of the existing advance pricing arrangement regime by providing it with a statutory basis.</th>
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<tr>
<td><strong>Action 14: Improving dispute resolution mechanism</strong></td>
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<tr>
<td>- To introduce a statutory mechanism to facilitate the handling of Mutual Agreement Procedure and arbitration cases.</td>
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<tr>
<td>- To enhance the current tax credit system by extending the time limit for making a fresh tax credit claim from 2 years to 6 years.</td>
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</table>

**Notes:**

1. The 6 categories of tax rulings are: (i) rulings relating to preferential regimes, (ii) unilateral advance pricing arrangements and any other cross-border unilateral rulings in respect of transfer pricing, (iii) cross-border rulings providing for a downward adjustment of taxable profits, (iv) permanent establishment ruling, (v) related party conduit ruling, and (vi) any other type of ruling that, in the absence of spontaneous information exchange, could give rise to BEPS concerns.

2. All enterprises which carry on trades or businesses in Hong Kong and engage in transactions with associated enterprises are required to prepare the master and local files. The master and local files should be prepared for each fiscal year and retained for a period of not less than 7 years after the year concerned. The maximum penalty for non-compliance without reasonable excuse is HK$100,000.

3. Enterprises (which are small private companies as defined in the Companies Ordinance) which satisfy any 2 of the following 3 conditions are **NOT required** to prepare the master and local files: (i) total annual revenue not more than HK$100 million, (ii) total assets not
more than HK$100 million, and (iii) no more than 100 employees.

4. The ultimate parent entity of an multinational enterprise group with annual consolidated group revenue of at least EUR750 million (or equivalent to HK$6.8 billion) is required to file CbC report. The CbC reports should be filed within 12 months from the last day of the fiscal year. The maximum penalty for non-compliance without reasonable excuse is HK$100,000 plus daily fine of HK$500.
Table 2: Key Features of Proposed Transfer Pricing Regime in Hong Kong

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<tbody>
<tr>
<td>1.</td>
<td>The fundamental transfer pricing (TP) rule is consistent with OECD’s Model Tax Convention and Transfer Pricing Guidelines.</td>
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<tr>
<td>2.</td>
<td>The fundamental TP rule empowers the Commissioner of Inland Revenue (CIR) to make TP adjustment on the profits or losses of an enterprise for a non-arm’s length dealings that has created a tax advantage.</td>
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<tr>
<td>3.</td>
<td>The fundamental TP rule applies to dealings between (i) associated persons (i.e., one person is directly or indirectly participating in the management, control or capital of the other, or a third person is participating in the same of both persons) and (ii) different parts of an enterprise (e.g., head office and a permanent establishment).</td>
</tr>
<tr>
<td>4.</td>
<td>The scope of the fundamental TP rule is sufficiently wide to cover not only transactions of assets and services, but also financial or business arrangements like the making of loans and cost contribution arrangements.</td>
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<tr>
<td>5.</td>
<td>A mechanism for corresponding relief resulting from TP adjustments made by the CIR or Comprehensive Double Tax Agreement partners.</td>
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<tr>
<td>6.</td>
<td>Penalty for incorrect tax returns arising from non-arm’s length pricing: (i) without reasonable excuse – the maximum penalty is HK$10,000 plus 3 times the tax undercharged or an administrative fine of not more than 3 times the tax undercharged and (ii) willfully with intent to evade tax – the maximum penalty is HK$50,000 plus 3 times the tax undercharged plus imprisonment for 3 years.</td>
</tr>
<tr>
<td></td>
<td>Offshore Funds Law</td>
</tr>
<tr>
<td>--------------------------------</td>
<td>-----------------------------------------------------------------------------------</td>
</tr>
</tbody>
</table>
| Profits Tax Exemption Provisions | • Apply to the non-resident person (i.e., offshore funds excluding private equity (PE) funds).<br>• Apply to year of assessment 1996/97 onwards.<br>• Satisfying ALL 4 conditions for exemption:<br>1. The person is a non-resident of Hong Kong.<br>2. Carries on specified transactions (excluding shares in private companies) and incidental transactions,<br>3. Does not carry on any trade or business in Hong Kong other than specified transactions and incidental transactions, and<br>4. Carried out through or arranged by specified person. | • Apply to the non-resident person (i.e., offshore funds including PE funds).<br>• Apply to year of assessment 2015/16 onwards.<br>• Satisfying ALL 4 conditions for exemption:<br>1. The person is a non-resident of Hong Kong,<br>2. Carries on specified transactions (including shares in special purpose vehicles (SPV) or excepted private companies) and incidental transactions,<br>3. Does not carry on any trade or business in Hong Kong other than specified transactions and incidental transactions, and<br>4. Carried out through or arranged by specified person or the non-resident person is
<table>
<thead>
<tr>
<th>Profits Tax Deeming Provisions</th>
<th>a qualifying fund.</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Apply to the Hong Kong investor.</td>
<td>• Apply to the Hong Kong investor.</td>
</tr>
<tr>
<td>• Apply to year of assessment 2006/07 onwards.</td>
<td>• Apply to year of assessment 2006/07 onwards (for section 20AE provisions) and year of assessment 2015/16 onwards (for section 20AF provisions).</td>
</tr>
<tr>
<td>• Deeming provisions apply when:</td>
<td>• Deeming provisions apply when:</td>
</tr>
<tr>
<td>1. Non-associated fund - the Hong Kong investor (together with its associates) has direct or indirect beneficial interest of at least 30% in the tax-exempt offshore fund, or</td>
<td>1. Non-associated fund - the Hong Kong investor (together with its associates) has direct or indirect beneficial interest of at least 30% in the tax-exempt offshore fund, or</td>
</tr>
<tr>
<td>2. Associated fund – the Hong Kong investor has any direct or indirect beneficial interest in the tax-exempt offshore fund that is an associate of the Hong Kong investor.</td>
<td>2. Associated fund – the Hong Kong investor has any direct or indirect beneficial interest in the tax-exempt offshore fund that is an associate of the Hong Kong investor, or</td>
</tr>
<tr>
<td>• Deeming provisions are not applicable if the offshore fund is bona fide widely held by the investors.</td>
<td>3. <em>Offshore PE fund has a beneficial interest in a tax-exempt SPV which does not distribute the profits to the fund.</em></td>
</tr>
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<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Table 4: Hong Kong Tax Implications on the Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect

Panel A: Mainland Investors in Southbound Trading Link

<table>
<thead>
<tr>
<th></th>
<th>Profits Tax (PT)</th>
<th>Salaries Tax (ST)</th>
<th>Stamp Duty (SD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mainland China</td>
<td>• Gains from the transfer of Hong Kong shares are not</td>
<td>Not applicable.</td>
<td>SD is payable on transfer of Hong Kong shares (at the rate of 0.1% on the higher of consideration or market value of the shares transferred, payable by both transferee and transferor).</td>
</tr>
<tr>
<td>Institutional Investors</td>
<td>chargeable to PT.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Dividend incomes</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>specifically exempt from PT.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mainland China</td>
<td>Gains from the transfer of Hong Kong shares are not</td>
<td>Gains from the transfer</td>
<td></td>
</tr>
<tr>
<td>Individual</td>
<td>chargeable to PT.</td>
<td>of Hong Kong shares</td>
<td></td>
</tr>
<tr>
<td>Investors</td>
<td>and dividend incomes are not chargeable to ST.</td>
<td>and dividend incomes</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>are not chargeable to ST.</td>
<td></td>
</tr>
</tbody>
</table>

Panel B: Hong Kong/Overseas Investors in Northbound Trading Link

<table>
<thead>
<tr>
<th></th>
<th>Gains from the transfer of Mainland China’s A-shares and dividend incomes are not chargeable to PT.</th>
<th>Not applicable.</th>
<th>Not applicable.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong/Overseas</td>
<td>Gains from the transfer of Mainland China’s A-shares are not</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Institutional Investors</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Gains from the transfer of Mainland China’s A-shares are not</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hong Kong/Overseas</td>
<td>Gains from the transfer of Mainland China’s A-shares and dividend</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investors</td>
<td>chargeable to PT.</td>
<td>incomes are not chargeable to ST.</td>
<td></td>
</tr>
</tbody>
</table>
Table 5: Mainland China Tax Implications on the Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect

### Panel A: Mainland Investors in Southbound Trading Link

<table>
<thead>
<tr>
<th></th>
<th>Corporate Income Tax (CIT)</th>
<th>Value Added Tax (VAT)</th>
<th>Individual Income Tax (IIT)</th>
<th>Stamp Duty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mainland China</td>
<td>• Gains from the transfer of Hong Kong shares are subject to CIT.</td>
<td>Gains from the transfer of Hong Kong shares are temporarily exempted from VAT.</td>
<td>Not applicable.</td>
<td>Not</td>
</tr>
<tr>
<td>Institutional</td>
<td>• Dividend incomes are generally subject to CIT.</td>
<td></td>
<td></td>
<td>applicable.</td>
</tr>
<tr>
<td>Investors</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mainland China</td>
<td>Not applicable.</td>
<td>Gains from the transfer of Hong Kong shares are temporarily exempted from VAT.</td>
<td>• Gains from the transfer of Hong Kong shares are temporarily exempted from IIT from 5 December 2016 to 4 December 2019.</td>
<td></td>
</tr>
<tr>
<td>Individual</td>
<td></td>
<td></td>
<td>• Dividend incomes will be subject to IIT of</td>
<td></td>
</tr>
<tr>
<td>Investors</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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Panel B: Hong Kong/Overseas Investors in Northbound Trading Link

<table>
<thead>
<tr>
<th>Hong Kong/Overseas Institutional Investors</th>
<th>Gains from the transfer of Mainland A-shares are temporarily exempted from CIT.</th>
<th>Gains from the transfer of Mainland A-shares are temporarily exempted from VAT.</th>
<th>Not applicable.</th>
<th>SD on the seller of Mainland A-shares at the rate of 0.1% of consideration.</th>
</tr>
</thead>
</table>

- Gains from the transfer of Mainland A-shares are temporarily exempted from CIT.
- Dividend incomes are subject to CIT of 10% on withholding basis.
| Hong Kong/Overseas Individual Investors | Not applicable. | Gains from the transfer of Mainland A-shares are temporarily exempted from VAT. | - Gains from the transfer of Mainland A-shares are temporarily exempted from IIT.  
- Dividend incomes are subject to IIT of 10% on withholding basis. |
Figure 1: Hong Kong Profits Tax Implications for Funds

- Securities and Futures Commission (SFC) authorized funds
  - Widely held funds
    - Supervised by overseas regulatory authority
      - Exempt
    - Non-supervised by overseas regulatory authority
      - Offshore funds
        - Qualifying for exemption under 2006/2015 Offshore Funds Law?
          - YES
            - Exempt
          - NO
            - Hong Kong funds
              - Qualifying for exemption under 2006/2015 Offshore Funds Law?
                - YES
                  - Nature of transaction
                    - Revenue
                      - Subject to tax
                    - Capital
                      - Not subject to tax
                - NO
                  - Nature of transaction
                    - Revenue
                      - Subject to tax
                    - Capital
                      - Not subject to tax
Figure 2: Profits Tax Implications for Offshore Fund Transactions

- **Offshore fund carries out**
  - **Specified transactions only**
    - All profits are exempt
  - **Specified transactions and incidental transactions**
    - Trading receipts from incidental transactions do not exceed 5% of total trading receipts
      - All profits from specified transactions and incidental transactions are exempt
    - Trading receipts from incidental transactions exceed 5% of total trading receipts
      - Profits from specified transactions: Exempt
      - Profits from incidental transactions: Taxable if sourced in Hong Kong
  - **Other trade or business transactions (i.e., not specified transactions and not incidental transactions)**
    - All profits are taxable if the fund carries on business in Hong Kong, transactions are revenue in nature, and profits are sourced in Hong Kong
Figure 3: Deeming Provisions for Offshore Funds

Part A: Non-Associated Fund (30% or more beneficial interest)

The deeming provisions may apply. 30% of the exempt profits of the offshore fund may be subject to profits tax in Hong Kong.

Reason: Hong Kong investor holds 30% beneficial interest in the non-associated offshore fund.

Part B: Associated Fund (any beneficial interest)

The deeming provisions may apply. 5% of the exempt profits of the offshore fund may be subject to salaries tax in name of the Hong Kong investor (i.e., director of the offshore fund) in Hong Kong.

Reason: Hong Kong investor (i.e., director of the offshore fund) is an associate of the offshore fund.
Figure 4: 10% Safe Harbor Rule for Excepted Private Company\textsuperscript{100}

Part A

Company A (incorporated overseas)

\begin{itemize}
\item Value of share capital HK$10
\item Value of share capital HK$10
\item Permanent establishment in Hong Kong
\item Permanent establishment in Hong Kong
\item Value of other overseas business assets HK$200
\end{itemize}

Company A qualifies as an Excepted Private Company.

Reason: The aggregate value of the share capital in Subsidiary X and Subsidiary Y, which carry on business in Hong Kong through a permanent establishment, does not exceed 10% of the value of the total assets of company A (i.e., HK$ (10+10) / (10+10+200) = 9.1%).

Company B does not qualify as an Excepted Private Company.

Reason: The aggregate value of the holding of the immovable property and share capital in Subsidiary Z exceeds 10% of the value of the total assets of company B (i.e., HK$ (55+15) / (55+15+600) = 10.4%).