



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. 20 (REVISED)

MUTUAL FUNDS, UNIT TRUSTS AND SIMILAR INVESTMENT SCHEMES

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 law as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

These notes replace those issued in June 1998.

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Commissioner of Inland Revenue

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INTRODUCTION

Section 26A(1A) of the Inland Revenue Ordinance (the Ordinance) provides tax exemption to sums derived from specified investment schemes in respect of mutual funds, unit trusts and similar investment schemes. The purpose of this Practice Note is to outline the provisions contained in section 26A(1A) and to lay down broad statements on the interpretation and practice to be adopted by the Inland Revenue Department in relation to the application of the section.

KEY ELEMENTS OF THE LEGISLATION

Taxpayers entitled to exemption

2. Section 26A(1A)(a) restricts the application of the section to the following categories of persons -

- “ (i) a person chargeable to tax under this Part in respect of a mutual fund, unit trust or similar investment scheme that is authorized as a collective investment scheme under section 104 of the Securities and Futures Ordinance (Cap. 571); or
- (ii) a person chargeable to tax under this Part in respect of a mutual fund, unit trust or similar investment scheme where the Commissioner is satisfied that the mutual fund, unit trust or investment scheme is a bona fide widely held investment scheme which complies with the requirements of a supervisory authority within an acceptable regulatory regime.”

The various types of qualifying schemes and other requirements are further discussed in the following paragraphs.

Mutual funds, unit trusts and similar investment schemes

3. The application of section 26A(1A) is restricted to mutual funds, unit trusts and similar investment schemes. It is of paramount importance to

understand the meaning of these terms.

4. “Mutual fund” and “unit trust” are defined in section 26A(2) as follows -

- (a) “mutual fund” means any arrangement made for the purpose, or having the effect, of providing facilities for investment in shares in a corporation which is or holds itself out as being engaged primarily in the business of investing, reinvesting or trading in securities and which is offering for sale or has outstanding any redeemable shares of which it is the issuer.
- (b) “unit trust” means any arrangement made for the purpose, or having the effect, of providing facilities for the participation by persons, as beneficiaries under a trust, in profits or income arising from the acquisition, holding, management or disposal of securities or any other property whatsoever.

They fall within the meaning of “collective investment scheme” under the Securities and Futures Ordinance (the SFO).

5. There is, however, no definition of “similar investment scheme” in the Ordinance. The reference to “similar investment scheme” in section 26A(1A) is intended primarily to cater for investment arrangements established under civil law which are in substance the same as unit trusts or mutual funds which fall within the scope of section 26A(1A), but have a different legal form (e.g. a “Fond Commun D’ Placement” which is essentially a contractual mutual fund, although not incorporated or established under trust). To be a qualified scheme, among others, the investors concerned should have no control over the management of the funds they have invested in the scheme (other than indirectly by being able to exercise voting rights in relation to the appointment of fund managers).

Conditions for exemption

6. Not all mutual funds, units trusts and similar investment schemes qualify for exemption automatically. To qualify for exemption, any such investment scheme must satisfy either one of the two alternative conditions, i.e.

(i) it is authorized as a collective investment scheme under the SFO; or (ii) where the Commissioner is satisfied that certain specified requirements are met. Paragraphs 7 and 8 below deal with the first condition while paragraphs 9 to 14 below deal with the second one.

Authorized collective investment schemes

7. From 1 April 2003 onwards, the Securities and Futures Commission (SFC) is given the power, under section 104(1) of the SFO, to authorize collective investment schemes (which include mutual funds and unit trusts) as it considers fair and reasonable. The conditions for authorization generally imposed by the SFC are set out in its “Code on Unit Trusts and Mutual Funds” (the Code) which is included in Section II of the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products. Briefly, the Code is divided into three parts which cover the following -

Part I: General matters

- (a) authorization procedures (such as the requirement that an applicant for authorization must submit a completed Application Form together with specified supporting documents);
- (b) recognition of schemes established in certain regulated jurisdictions;
- (c) nomination of an individual as an approved person;
- (d) set up of a Products Advisory Committee by the SFC to consult and advise on matters relating to collective investment schemes; and
- (e) definitions of terms used in the Code (“collective investment scheme” or “scheme” means collective investment schemes commonly regarded as mutual funds (whether they appear in the legal forms of contractual model, companies with variable capital or otherwise) and unit trusts).

Part II: Authorization requirements

- (f) role of the trustee/custodian (every collective investment scheme for which authorization is requested must appoint a trustee, in the case of a trust, or a custodian, for a mutual fund, acceptable to the SFC);
- (g) role of the management company (every collective investment scheme for which authorization is requested must appoint a fund management company acceptable to the SFC, except as provided in the Code for cases where a scheme's own board of directors are to perform the functions of a management company);
- (h) appointment of the auditor for the scheme;
- (i) operational requirements (in respect of scheme documentation; maintenance of a register of holders; information detailing investment plans; pricing, issue and redemption of units/shares; general meetings of the holders of units or shares; and fees);
- (j) core requirements of the investment limitations and prohibitions, other than for specialized schemes (e.g. a scheme is prohibited from, among others, investing in any type of real estate (including buildings) or interests in real estate (including options or rights, but excluding shares in real estate companies and interests in real estate investment trusts (REITs));
- (k) guidelines for various specialized schemes (i.e. any scheme whose primary objective is not investment in equities and/or bonds; any scheme falling under the categories specified in Chapter 8 of the Code, namely unit portfolio management funds, money market/cash management funds, warrant funds, futures and options funds, guaranteed funds, index funds, hedge funds, structured funds, and funds that invest in financial derivative instruments; or any scheme which

otherwise does not meet the core requirements of the investment limitations and prohibitions referred to above); and

- (l) additional requirements for non-Hong Kong based schemes (cover matters such as the requirement that a Hong Kong representative must be appointed if the scheme's management company is not incorporated and does not have a place of business in Hong Kong; appointment criteria; functions of a representative; details of all contracts between the representative, the scheme and/or the management company must be supplied to the SFC; and jurisdiction of the courts of Hong Kong to entertain an action concerning the scheme).

Part III: Post-authorization requirements

- (m) operational matters (in respect of valuation and pricing of a scheme; pricing errors; changes to the method of dealing; suspension and deferral of dealings; and transactions with connected persons); and
- (n) documentation and reporting requirements (in respect of proposed changes to constitutive documents, of key operators and in investment objectives, policies and restrictions, fee structure and dealing and pricing arrangements; notices to holders; intention not to maintain authorized status; merger or termination; reporting to holders; reporting to the SFC; and advertising materials).

The Code also includes six appendices: Information to be disclosed in the offering document; Contents of the constitutive documents; Contents of financial reports; Guidelines for review of internal controls and systems of trustees/custodians; Guidelines on hedge funds reporting requirements; and Guidelines for regulating index tracking exchange traded funds.

8. For detailed guidance as to the conditions for authorization imposed by the SFC, reference should, of course, be made to the current version of the Code, which is available on the website of the SFC.

Non-authorized collective investment schemes

9. With effect from the year of assessment commencing 1 April 1996, section 26A(1A) was amended so that in addition to having application to authorized mutual fund corporations and the trustees of authorized unit trusts, it also applies, where certain requirements are satisfied, to a mutual fund corporation established outside Hong Kong, a trustee of a unit trust established outside Hong Kong and a person chargeable to Profits Tax in respect of any other similar collective investment scheme. In each case (i.e. where the scheme is not authorized by the SFC), the concessions provided by the section only apply where the Commissioner is satisfied that the scheme is (i) “bona fide widely held”; and (ii) “complies with the requirements of a supervisory authority within an acceptable regulatory regime” (collectively hereinafter referred to as the “specified requirements”).

The specified requirements

“bona fide widely held”

10. Section 26A(1A) does not define what is meant by a “bona fide widely held” scheme. However, it may be presumed that this requirement is satisfied if during the year of assessment in question at no time did fewer than 50 persons hold (or have the right to become the holders of) all of the units or shares in the scheme, and at no time during the year did fewer than 21 persons hold (or have the right to become the holders of) units or shares that entitled the holders, directly or indirectly, to 75% or more, of the income or property of the scheme.

11. Where the above benchmark figures are not met, it will still be accepted in practice that the requirement has been satisfied if it is clear from the constitutive documents of the scheme and other relevant material that it was established with a view to wide public participation and that genuine efforts are being taken with the aim of achieving that objective (i.e. there is nothing to suggest that the scheme is intended to be a closely held investment vehicle). This situation could arise, for example, where a scheme has only recently been established or where, despite the wishes of the parties concerned, it has proved to be unpopular with investors.

“complies with the requirements of a supervisory authority within an acceptable regulatory regime”

12. It will be accepted, unless there is evidence to the contrary, that a scheme qualifies in this respect if it is a scheme of a kind set out in the list of recognized jurisdictions published on the SFC’s website (Recognized Jurisdictions Schemes) and has received recognition of such status from the supervisory authority corresponding to the SFC in the jurisdiction concerned.

13. For any other case it will be necessary for the parties seeking the application of section 26A(1A) to provide the Department with full details of the nature of the scheme and the regulatory regime under which it operates. Supporting documentary material should be provided, including copies of the material submitted to the supervisory authority of the regime concerned and confirmation from the authority that the scheme complies with the requirements of the regime.

14. In essence, a regulatory regime will be regarded as acceptable if it not only lays down standards for collective investment schemes which are comparable to those detailed in the Code, but also actively promotes compliance (e.g. through enforcement measures such as the application of inspection standards and the utilization of arrangements with other jurisdictions for the exchange of information concerning investment management persons).

Advance rulings

15. Where a scheme is of a kind referred to in paragraph 12 above and is widely held in terms of the test specified in paragraph 10, it may be accepted without confirmation from the Department that the scheme falls within section 26A(1A)(a) (exemption will, however, only apply if section 26A(1A)(b) is satisfied - see paragraphs 17 and 18 below). If, on the other hand, such a scheme is not widely held in terms of the test, the application of section 26A(1A)(a) cannot be presumed. In the latter situation, a request may be made to the Commissioner for a ruling on the question of whether it can be accepted that the requirements of the subsection are satisfied. Such a request should be accompanied by information and relevant documentary evidence to support the contention that the scheme was established with a view to wide public participation (see paragraph 11 above) and to substantiate that it is of a

kind described in paragraph 12. Please refer to Departmental Interpretation & Practice Notes No. 31 on the procedures and requirements for making such an “advance ruling”.

16. Applications for rulings may also be made to the Commissioner in respect of collective investment schemes which are not of a kind referred to in paragraph 12. An application in respect of such a case should be accompanied by material sufficient to enable the Commissioner to decide whether or not he is satisfied that the scheme meets the relevant specified requirements discussed in paragraphs 10 to 14 above.

Sums which qualify for exemption

“specified investment scheme”

17. The scope of the section 26A(1A) exemption is limited to sums which are received by or accrued to a qualifying person in respect of a “specified investment scheme”. The meaning of this term is set out in paragraph (b) of that section. In essence, the term applies to an investment scheme which satisfies two requirements, namely -

- (i) the investment scheme must be carried on for the purposes for which it was stated to be carried on in the constitutive documents approved by the relevant supervisory authority (i.e. by the SFC in the case of an authorized mutual fund, unit trust or similar investment scheme, or by the supervisory authority within an acceptable regulatory regime in the case of a scheme which has not been authorized by the SFC but falls within subsection (1A)(a)(ii)); and
- (ii) the investment scheme must be carried on in accordance with the requirements of the SFC or the supervisory authority within the acceptable regulatory regime, as the case may be.

18. It should be noted that as a consequence of the amendments made in 1998, section 26A(1A) no longer restricts exemption to specified categories of sums derived by a qualifying fund. Exemption instead hinges on the questions of whether a sum has been derived from an activity which has been

approved by the relevant supervisory authority, and whether the activity has been conducted in accordance with the requirements of the authority.