Hong Kong Institute of
Certified Public Accountants
香港會計師公會

BY FAX AND BY POST
(2530 5921)

Our Ref.: C/TXG, M33043 31 January 2005

Principal Assistant Secretary for the Treasury (Revenue),
Treasury Branch,
Financial Services and the Treasury Bureau,
4th Floor, Central Government Offices, Main Wing,
Lower Albert Road,
Hong Kong.

Dear Sirs,

Consultation Paper on Exemption of Offshore Funds from Profits Tax

Thank you for inviting the Hong Kong Institute of Certified Public Accountants (HKICPA) to comment on the *Consultation Paper on Exemption of Offshore Funds from Profits Tax* issued in December 2004 ("the consultation paper"). Our views are set out below.

General comments

To put into effect the government's announcement in the 2003/04 Budget to exempt offshore funds from profits tax, the proposed legislation is intended to reinforce Hong Kong's status as an international financial centre by increasing its attraction to offshore fund managers and bringing Hong Kong into line with other major international financial centres, where offshore funds are generally not subject to tax. As such, we believe that it is important for any such legislation to be effective and workable in practice and, generally, to give an appropriate signal to the financial markets.

We note that under the revised approach put forward by the Administration, two sets of provisions would be introduced into the Inland Revenue Ordinance ("IRO") – the Exemption Provisions and the Deeming Provisions. We also note that the proposals are similar to those outlined to representatives of the HKICPA at a meeting with the Administration held on 8 December 2004.

Generally, we consider the revised approach to be an improvement over the proposals under the former approach; in particular, we support the dropping of the proposed rules for tracing beneficial interests in the fund vehicle. However, we have concerns regarding specific aspects of the revised approach and suggest that clarification is required in relation to certain key terms referred to under the revised approach.

4th Floor, Tower Two, Lippo Centre,
89 Queensway, Hong Kong
香港金鐘道89號力寶中心二座四樓
Tel 電話 : (852) 2287 7228
Fax 傳真 : (852) 2865 6776
(852) 2865 6603
Web 網址 : www.hkicpa.org.hk
E-mail 電郵: hkicpa@hkicpa.org.hk

Specific comments

Exemption Provisions

(a) Definition of "resident/non-resident fund"

The term "resident" is key to the Exemption Provisions and the Deeming Provisions. Specifically, the Exemption Provisions would grant profits tax exemption to a non-resident (including an individual, a partnership, a trustee and a corporation) without regard to the composition of its beneficial owners. The Deeming Provisions would deem assessable profits on a resident holding beneficial interest in a tax-exempt non-resident under certain circumstances. Yet the term "resident" has not been defined in the existing provisions of the IRO and no suggested definition has been put forward in the consultation paper.

Typically, as pointed out in our submission on the former approach, dated 25 February 2004, many offshore funds that carry out securities trading transactions in Hong Kong are formed, promoted and operated by Hong Kong-based investment advisers/fund managers. These managers and funds generally have common directors or principals. It is the norm for these managers to have an ownership interest in the offshore funds.

Under such arrangements, the Hong Kong-based managers would be able to exercise the day-to-day management and control of the funds, but it is the investors who would be entitled to the capital and income of the fund.

We are concerned that if the residency of a corporation is to be determined by reference to, for example, the place where it is centrally managed and controlled or otherwise carrying on business, funds that are managed by Hong Kong-based managers would be considered to be "resident" in Hong Kong and, therefore, would fall outside the scope of the Exemption Provisions. We believe that a fund that is managed, controlled or operated by Hong Kong-licensed investment advisers/fund managers should not, simply by virtue that reason, be regarded as "resident" for the purpose of the Exemption Provisions.

We would suggest instead that consideration be given to basing the exemption on a test that looks only to the residency of the *immediate investors* in the fund. For example, in the case of a company, provided that it is incorporated outside of Hong Kong and the percentage ownership of the non-resident investors attains a certain threshold, say 80%, the fund should qualify as tax-exempt. This would not be inconsistent with the tests adopted by other jurisdictions and would be an appropriate way to ensure that the exemption would apply only to funds that are offshore in nature.

(b) Section 20AA, IRO, brokers/investment advisers

As in the case of the former approach, profits qualified for exemption under the revised approach are profits derived from securities trading transactions carried out in Hong Kong through s.20AA, IRO, brokers/investment advisers.

We believe that the proposed application of all the requirements of s.20AA would mean that many offshore funds would not be eligible for the exemption. Specifically, s.20AA(3) requires, inter alia, that the approved investment adviser must not have been an associate of the non-resident person during the year of assessment and that the approved investment adviser must be acting for the non-resident person in an independent capacity. However, as we have previously pointed out, since many of the offshore funds are formed, promoted and operated by investment advisers/fund managers, they effectively control the fund corporations or entities, by sharing with them common directors/principal officers, etc. Thus, the proposed application of all the requirements of s.20AA would render many offshore funds ineligible for the exemption.

We reiterate the view expressed in our previous submission that the "associate" test under s.20AA, which is unduly restrictive and onerous, should not limit the operation of the exemption.

To enhance the attractiveness of Hong Kong as a place for fund managers to set up their operations, therefore, we recommend removing the nexus between the Exemption Provisions and s.20AA in its entirety or, as a minimum, between the provisions and the "associate" test under s.20AA.

(c) Non-resident person carrying on any other business in Hong Kong

The consultation paper suggests that the availability of the profits tax exemption is subject to the requirement that the non-resident person must not carry on any other business in Hong Kong.

While the rationale behind this proposed requirement may be to extend the exemption only to funds that are offshore by nature, this requirement may be difficult to satisfy in practice, as it is common for funds to appoint Hong Kong administrators and custodians as agents of the non-resident fund. Accordingly, this requirement could affect the tax-exempt status of some non-resident funds, if such ancillary administrative and custodian services were to be regarded as amounting to the carrying on of a business by the fund in Hong Kong. For Hong Kong profits tax purposes, it is generally accepted that very little needs to be performed on behalf of a non-resident in order for that non-resident to be considered as carrying on business in Hong Kong.

In our view, the fact that miscellaneous and ancillary services are performed on behalf of an otherwise non-resident fund in Hong Kong should not adversely affect the overall tax-exempt status of the fund.

One possible alternative would be to set out a list of permissible ancillary services that the fund could undertake in Hong Kong without impacting on the fund's non-resident and exempt status, possibly in a Departmental Interpretation and Practice Note on the intended application of the proposed provisions.

(d) Definition of securities

The consultation paper seems to suggest that if a fund is to make an investment, other than in securities that fall within the definition of "securities" in Schedule 1 to the Securities and Futures Ordinance (Cap.571), such an investment could taint the entire exempt status of the fund. The term "securities" as defined may not include, for example, certain typical income of a fund, such as stock borrowing and lending fees, interest and foreign currency income. Further, it is unclear from the consultation paper whether, in the case of a fund with investment in "securities" as defined and other investments, the exemption would continue to apply to the profits from investments that in fact fall within the definition of "securities".

We suggest that the types of exempted income should be suitably broadened to cover all types of income incidental to securities trading, so as to reflect the legislative intent of the exemption.

We also believe that the legislation should be drafted to provide that the fact that certain investments did not fall within the definition of "securities" would not taint the exemption status of the fund in prescribed circumstances, or otherwise affect the exemption of profits from investments falling within the definition of "securities".

One option would be to introduce a *de minimis* test in the legislation, such that the overall tax-exempt status of the fund would not be affected by the fund's Hong Kong investments that did not fall within the definition of "securities", where the *de minimis* test was satisfied.

<u>Deeming Provisions</u>

(e) Beneficial interest held by a resident investor

Based on the outline of the Deeming Provisions in the consultation paper, we understand that such provisions, if enacted, would apply to a resident investor, who alone or with his associates, holds a certain percentage, say, 30% or more of the beneficial interest in a tax-exempt non-resident.

We have doubts about the effect of introducing Deeming Provisions as part of the proposed legislative framework. We would suggest that the provisions, as outlined, are potentially complex and may be at odds with the current Hong Kong tax law, in that, e.g., Hong Kong-resident investors may become subject to tax on Hong Kong-sourced trading profits derived by another entity (i.e. the fund).

Furthermore, while resident corporations are currently subject to profits tax on their securities trading income, resident individuals are rarely subject to profits tax on their income from securities. In view of the purpose of the proposed exemption to reinforce the status of Hong Kong as an international financial centre, it may not be warranted to subject resident individuals to tax under the Deeming Provisions in respect of the securities trading income of their invested funds.

In addition, we foresee practical difficulties in computing the level of ownership of a Hong Kong resident investor in a tax-exempt non-resident, in situations where the resident investor is required to take account of interests held directly or indirectly by associates.

(f) Deemed assessable profits

It appears that the Deeming Provisions may operate whether or not any actual distributions have been made by the non-resident fund to a Hong Kong resident investor. This could mean that the resident investor would be subject to tax on unrealised profits, which the resident has not derived and may never derive (e.g. if the investor disposed of its interest in the fund prior to receiving a distribution). Also, we envisage a potential risk of double taxation arising if the resident might be assessed on deemed profits and again on the disposal of its investment in the fund.

For the above reasons, we have some reservations over the operation of the Deeming Provisions and over any perceived necessity of applying such provisions to counteract "round tripping" transactions. We believe that the existing provisions of the IRO should already be sufficient to address such arrangements.

Conclusion

As indicated above, we find the broad concept behind the Exemption Provisions as set out under the revised approach to be an improvement over the previous approach. However, the way in which "resident" and "non-resident" funds will be defined is fundamental to the concept and needs to be clarified. We also suggest consideration of the alternative approach of basing the proposed exemption on a test that looks only to the residency of the *immediate investors* in the fund.

We have doubts about broad implications and practical effects of introducing the Deeming Provisions.

I hope that you find our comments to be constructive. If you have any questions in relation to this submission, please do not hesitate to contact me at peter@hkicpa.org.hk or on 2287 7084.

Yours faithfully,

PETER TISMAN
TECHNICAL DIRECTOR
(BUSINESS MEMEBRS & SPECIALIST PRACTICES)

PMT/JT/ay