HONG KONG SOCIETY OF ACCOUNTANTS
(Incorporated by the Professional Accountants Ordinance, Cap. 50)

香港會計師公會

BY FAX AND BY POST
(2861 1494)

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Financial Services Branch,
Financial Services and the Treasury Bureau,
18/F., Admiralty Centre Tower I,
18 Harcourt Road
Admiralty,
Hong Kong.

(Attn: Consultation on Exemption of
Offshore Funds from Profits Tax)

Dear Sirs,

Consultation on Exemption of Offshore Funds from Profits Tax

Thank you for inviting the views of the Hong Kong Society of Accountants (HKSA) on the proposed amendments to the Inland Revenue Ordinance ("IRO"), to put into effect the Government's announcement in the 2003/04 Budget to exempt offshore funds from profits tax.

The draft legislation proposes to exempt the profits derived by offshore funds by linking the new provision (section 20AB of the IRO) with the existing provisions applying to approved investment advisors and brokers (s20AA, which exempts brokers and approved investment advisors from being treated as agents of non-resident persons, provided certain conditions are met). Accordingly, under the proposed legislation, a non-resident person will be exempt from profits tax on profits derived from transactions undertaken through an agent who is a broker or an approved investment advisor where certain conditions are satisfied.

General comments

The aim of the proposed legislation is 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. This being the case, it is important that any legislation introduced to achieve this purpose is workable and effective and that, generally, it will convey the appropriate message to the financial markets. We have doubts as to whether the proposed legislation will meet these requirements and we believe that, although statutory changes to implement the 2003/04 Budget announcement have been anticipated for some time, it would be better to delay their introduction for a further period of time, rather than proceeding with amendments to the IRO that may not have the desired effect.

The Society has the following general observations in respect of the proposed legislative provisions:

- The proposed exemption provisions will have retrospective effect from the 1997/98 year of assessment and will apply to funds, individuals, partnerships, trusts and corporations

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that are resident outside of Hong Kong. The retrospective operation of the legislation is presumably designed to offer additional comfort and certainty to funds that may have had previous profits tax exposure in Hong Kong.

- To meet the non-resident threshold, the draft legislation imposes a requirement that non-residents must hold at least an 80% interest in the offshore fund in order to qualify. The implications of this requirement are discussed under the heading "Specific comments" below.

- Under the current draft proposals, the non-resident requirements seek to lift the veil of corporate ownership to identify the individual beneficial ownership. The test to be applied in this respect is unclear in the context of listed groups and will require further clarification.

- An offshore fund will also need to satisfy the existing conditions for exemption under s20AA of the IRO. Section 20AA (2) requires, inter alia, that the broker should not have been an associate of the non-resident client during the year of assessment. Section 20AA(3) requires, inter alia, that for dealings between an approved investment adviser and a non-resident, the parties must be dealing with each other in an independent capacity and must not be associated.

<u>Specific responses to consultation questions</u>

The Society's comments in respect of the specific questions raised in the consultation paper are as set out below.

(a) As far as tax incentives are concerned, do you agree that the proposed legislation is sufficient for attracting offshore funds to Hong Kong and enabling Hong Kong to compete with other countries with similar exemptions on a level playing field? If not, why not and what other aspects do we need to consider?

While the proposed s20AB of the IRO is designed to offer an exemption from profits tax to offshore funds, many offshore funds may not fall within the proposed exemption as it is currently drafted.

Currently, the proposed exemption requires offshore funds to meet the non-resident percentage threshold (not less than 80%) and to comply with the existing provisions of s20AA of the IRO. The Society believes that this exemption is likely to be inadequate in practice as offshore funds that satisfy the 80/20 criterion will not be exempt if the qualifying concessions of s20AA are not also fulfilled.

Specifically, s20AA(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.

Typically, 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, even though they may only have a minimal or no beneficial interest in the funds. Thus, by having Hong

Kong based directors/principal officers, the funds may not be regarded as non-residents of Hong Kong and, therefore, not fall within scope of the exemption under the proposed s20AB.

In addition, transactions of these offshore funds carried out through local investment advisers/fund managers also appear in most cases not to be covered by section 20AA and, therefore, the proposed section 20AB, on the basis that the investment advisers/fund managers are either associates of the non-residents or they are not normally acting in an independent capacity for the non-residents.

Therefore, the legislation as drafted may not extend to a number of offshore funds that have investment advisory operations in Hong Kong. It is unclear from the wording of s20AB of the IRO whether this is an intended effect contemplated by the drafters of the proposed legislation.

(b) Do you think the proposed anti-avoidance provisions in section 20AB(2) are effective in preventing round-tripping of local funds from taking advantage of the tax exemption? If not, why not and what other elements should be included?

As noted above, the anti-avoidance rules appear somewhat onerous and in practice would prevent the exemption being extended to offshore funds that should otherwise qualify. The Society believes that, as an alternative, therefore, the general anti-avoidance provisions in s61A of the IRO should be used to prevent round-tripping of local funds in order to take advantage of the tax exemption.

Under the current draft proposals, the non-resident threshold test requires corporate ownership (or trust, or partnership, as the case may be) to be made transparent to reveal the individual beneficial ownership. How this “look-through” test will work is unclear in the context of listed groups and will require further clarification. For instance, it would be highly onerous, or even impracticable, for a multinational listed company to have to furnish information regarding the ultimate individual shareholders of its holding company, in order to demonstrate that the 80% non-resident threshold has been satisfied. The Society is of the view that any such test would need to be significantly simplified in its application to listed or publicly-owned companies.

(c) Do you consider the 80% threshold in section 20AB(2)(b) reasonable? If not, why not and what is the threshold you consider appropriate?

While we note that the 80% non-resident threshold, as proposed under s20AB(2)(b), has been adopted in Singapore, we are not convinced that this is the appropriate threshold, rather than, say, a simple majority. We are also not convinced, whatever ownership threshold is adopted, that it should be applied on an “at any time” basis rather than on the basis of, e.g. an average over a period. The Society believes that more discussion is called for on these aspects of the proposals, which is one reason why we are calling for the introduction of the proposals to be deferred.

(d) *Would you have difficulty in complying with the record-keeping requirement options set out in paragraph 15? If yes, please provide details about the difficulties and your other suggestions which can achieve the same purpose.*

The Society considers the record-keeping requirements set out under paragraph 15 to be potentially onerous on the broker/approved investment adviser, particularly option (a) under which the types of records as set out under Annex B are required to be maintained. This would in practice necessitate a great deal of administration and information-collecting on the part of the broker/approved investment adviser.

Option (b), which requires the broker/approved investment adviser to obtain confirmations from all non-resident clients that the criteria for tax exemption are met, may be less onerous for the broker/approved investment adviser. However, it would appear to require the non-resident client to understand and interpret Hong Kong law and, in this respect, we note that, for example, the terms "Hong Kong resident"/"non-Hong Kong resident" are not defined for the purposes of the proposed new s20AB. There are also the practical difficulties, referred to above, of determining beneficial ownership in the case of large listed companies.

Additional comments on the legislative proposals

In the light of the above, the Society's view is that the shortcomings in the proposed legislative amendments could result in their being ineffective in practice. Our further comments below include some suggestions for modifications to the proposed legislative amendments that could help to address the deficiencies in the current proposals.

Operation of the "look-through" test

One major deficiency in the proposed legislation relates to the operation of the proposed tracing rules to determine the residency of an investor. As we have pointed out above, under the draft legislation, the determination of the "non-resident" status of fund requires ascertaining the ultimate individual beneficial ownership. Although the proposed test may not be difficult to apply in simple corporate structures, its application in the context of more complex ownership structures would be difficult, if not unrealistic, in practice.

Furthermore, under the IRO, a person is generally only liable to profits tax if the person carries on business in Hong Kong and derives Hong Kong-sourced profits from that business. Therefore, it would seem to be questionable for the test to be concerned with traditional concepts of residency. Instead, it would be more appropriate for the test to be directed at identifying whether an investor is considered to be carrying on any other business in Hong Kong and so liable to tax. At the same time, the question arises, as to why "Hong Kong residents" that conduct no other business activities in Hong Kong should be limited to beneficially owning no more than 20% of a relevant fund?

The Society believes that the "round-tripping" rules should operate to prevent persons, who otherwise carry on business in Hong Kong, from escaping a liability to Hong Kong tax through an offshore fund. As such, as an alternative to the residency test, therefore, consideration could be given to adopting a test of determining whether an investor, regardless of residency, is "carrying on any other business in Hong Kong", either in its own right, or through an agent. This could be given effect by, for example, requiring fund managers to obtain a statutory declaration from investors at the time that they make the investment.

Removing the nexus between sections 20AB and 20AA

Another potentially serious flaw in the proposed exemption under s20AB arises from linking the exemption to the conditions required to satisfy s20AA. The draft proposal currently provides that an offshore fund would need to satisfy all of the existing conditions of s20AA of the IRO in addition to the non-resident threshold in order to qualify for exemption.

The conditions under s20AA (3) require, inter alia, that the approved investment adviser must not have been an associate of the non-resident during the year of assessment and that the approved investment adviser must be acting for the non-resident person in an independent capacity. An "associate" is defined very broadly under s20AA (6). For the purposes of the currently proposed exemption, therefore, as the operation of s20AB is conditional upon the satisfaction of the requirements in s20AA, where an offshore fund and the Hong Kong broker or approved investment adviser are associated, then the profits tax exemption would not apply to the investment vehicle, even if the non-resident threshold of s20AB was satisfied.

The Society is of the view that the "associate" test under s20AA, which is unduly restrictive and onerous, should not limit the operation of s20AB.

With a view to preventing round-tripping, which is the primary tax mischief that the anti-avoidance provisions in s20AB are designed to prevent, the Society considers that it would be more effective to remove the s20AA "associate" and "independence" tests in the application of s20AB and rely primarily on the test of whether the relevant parties "carry on any other business in Hong Kong". Other fund management centres (e.g. Singapore) provide that an offshore fund qualifies for exemption if it satisfies a non-residency threshold. The fact that the broker or approved investment adviser are associated entities, or may not be acting in an independent capacity, does not affect the application of the exemption. Moreover, as indicated above, the Society believes that, as an alternative, the general anti-avoidance provisions in s61A may be applied to prevent round-tripping of local funds to take advantage of the tax exemption.

However, as a policy matter, consideration might be given to introducing a provision to the effect that, where a Hong Kong-based investment adviser/fund manager (including any of its associated companies) owns more than a certain proportion of the capital of an offshore fund (e.g. 20%) for an extended period, that portion of the income of the fund that is attributable to the investment adviser/fund manager's share, should be brought into the Hong Kong's tax net.

If, ultimately, the "associate" and "independence" requirements were not to be applied to an offshore fund, which otherwise satisfied the non-resident threshold, the linking of the operation of s20AB to s20AA would serve no substantive purpose; in which case, s20AB as currently proposed could be redrafted to remove the requirement that, for the exemption to apply, the conditions in s20AA must also be satisfied. In this were to be done, the redrafted exemption provision could be introduced into the existing s26A of the IRO, which applies to instances where certain profits are excluded from profits tax. Section 26A seems to be a more appropriate provision in which to incorporate the offshore fund exemption.

Other matters

Procedure of confirmation of eligibility by non-resident investors

The Society has also been invited to comment on the above subject in a separate letter of 13 February 2004 from the Permanent Secretary for Financial Services and the Treasury (Financial Services). Our view of the proposed procedure is that, prima facie, the procedure appears to be relatively straightforward from the point of view of brokers/approved investment advisers. The reservations that the Society has about the procedure are reflected in our response to question (d) above, particularly as this relates to option (b). It also needs to be clarified whether, under the proposed procedure, brokers/approved investment advisers would be expected to retain any supporting evidence in respect of e.g., the questions of "association" and "independence" under s20AA(3), or whether the onus and liability would be entirely on the non-resident clients to determine and declare such matters.

We should emphasise that the Society's comments on the procedure are subject to the Society's overall views on the proposed legislation, in relation to which our concerns are reflected in this submission.

Abolition of estate duty on investments in exempted funds

Although not directly related to the legislation at hand, given that the objective of the proposed legislative changes is to enhance Hong Kong's position as an international financial centre, we also take this opportunity to reiterate a proposal made in our Budget Proposals 2004/05, submitted to the Financial Secretary in December 2003. We believe that the abolition of estate duty would encourage the further development of private banking and reinforce Hong Kong's position as a major financial centre. More specifically, in relation to offshore funds, we would suggest that estate duty be abolished at least on investments in funds exempted from profits tax under the IRO.

If you have any questions on this submission, please do not hesitate to contact me by telephone (on 2287 7084) or email (at peter@hksa.org.hk).

Yours faithfully,

PETER TISMAN
TECHNICAL DIRECTOR
(BUSINESS MEMBERS & SPECIALIST PRACTICES)

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