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25 October 2005

Hon. James Tien Pei-chun, GSB, JP
Chairman of the Bills Committee
Legislative Council
Legislative Council Building
8 Jackson Road
Central
Hong Kong

Dear Sir

Bills Committee on
Revenue (Profit Tax Exemption for Offshore Funds) Bill 2005

It is worth remembering that the issue which gave rise to this legislation was the taxation of investment funds.

Hong Kong aspires to be an international fund management centre. Investment funds play a vital role in any fund management centre because they expand the investor base: there are simply not enough investors who can afford their own segregated portfolio to sustain a significant asset management industry in Hong Kong. Investment funds provide cost efficiencies and diversification which facilitate stock market investment by a wide spectrum of investors.

It is an essential feature of international investment funds that they must be tax efficient: a fund will not be attractive to the international investing community unless it is at least as efficient from a tax perspective for the investor to invest in the fund as if he invested directly in the underlying portfolio. If there is even a perception that a fund will be subject to tax in the jurisdictions where it is domiciled, resident or managed, international investors will not invest. The reason for this is primarily that the investor may effectively be taxed twice, once when he suffers his share of the tax borne by the fund, and once when he is taxed on his disposal of his interest in the fund.

Please note that the Financial Services practice group's new fax number is **+852 2826 5375**

The tax borne by the fund affects him indirectly because it reduces the value of his investment. The tax on his disposal obviously affects him directly.

Take for example an investor who carries on a business of dealing in securities. If he trades in a Hong Kong listed stock directly, he will be subject to Hong Kong profits tax on any profit he makes. If instead he invests in an investment fund which trades the same stock, and the investment fund is taxed on profits derived from that stock, the investor effectively suffers tax twice: once at the fund level, when he bears his proportionate share of the tax borne by the fund, and again when he is taxed on profits he derives from the disposal of his interest in the fund. It is clear therefore that if the fund is taxed the investor is better off to invest directly rather than through a fund.

The funds industry contributes significantly to the Hong Kong economy. In particular, the non-public, unauthorised fund industry, which is strongly international in nature, is the part of the industry which has experienced the most growth in Hong Kong in terms of providing employment, contributing to the economy and sustaining other businesses and service industries in Hong Kong.

It is an industry which requires the right conditions in order to flourish. For example, the UK's international offshore industry was largely based in the Channel Islands during the 1970's and 80's because of fears that an unregulated fund managed onshore could be subject to UK tax. When these fears were resolved in the1990's, management of offshore funds was brought onshore to the UK. Now concerns are again being raised about the potential liability to UK tax of London managed funds, and the industry is beginning to shift towards the Channel Islands again.

In Hong Kong, it is only Hong Kong sourced profits which are at issue, but overseas investors do not understand that. This misconception discourages overseas investors from investing in Hong Kong managed funds. The growth of the industry has been sustained by the strong assurances from senior government officials that offshore funds would be exempted from tax. It is essential to the future of the Hong Kong fund management industry that those promises are fulfilled.

Yours faithfully

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