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(English version only)

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Our Ref: FC/vy

2 September 2005

The Bills Committee
Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005
Legislative Council Building
8 Jackson Road
Central
Hong Kong

Attention: Ms. Debbie Yau

Dear Sir,

REVENUE (PROFITS TAX EXEMPTION FOR OFFSHORE FUNDS) BILL 2005

Thank you for inviting us to make a submission regarding the captioned Bill. We set out below our comments from both policy and practical standpoints.

BACKGROUND

Under the current tax legislation, funds that are authorised by the Securities and Futures Commission ("SFC") or those that are widely held and overseas regulated are exempt from Hong Kong profits tax. Non SFC-authorised funds that are not widely held, on the other hand, are not exempt from tax but nonetheless play a vital role in Hong Kong's asset management industry.

Based on a recent survey by the SFC[1], assets under management by SFC-authorised funds totaled $352 billion whereas those of non SFC-authorised funds totaled in excess of $650 billion. Furthermore, in terms of growth, in 2004 non SFC-authorised funds registered a 63% increase in assets under management, outpacing SFC authorised funds by having the largest year-on-year increase among all segments of Hong Kong's asset management industry.

To promote Hong Kong's asset management industry and in turn reinforce the status of Hong Kong as an international financial centre, we feel that it is important to extend taxation relief to non SFC-authorised funds that are not currently exempt.

[1] "Fund Management Activities Survey 2004" issued in July 2005

The Bill seeks to exempt non-resident funds whose business activities in Hong Kong are restricted to the three types of regulated activities under the Securities and Futures Ordinance ("SFO"), i.e., dealings in securities, futures contracts, and leveraged foreign exchange trading through certain specified persons (the "specified transactions") and transactions incidental thereto.

For a fund vehicle which takes the form of a corporation, a partnership or a trust, the term "non-resident" as used in the Bill refers to that whose central management and control is exercised outside Hong Kong.

Before we make our specific submission on the Bill, we would like to briefly describe the common fund operational models adopted by the industry. These are as follows:-

1. Funds that are centrally managed and controlled outside Hong Kong and have non-HK fund managers ("Type I funds" as depicted in Appendix 1).

2. Funds that are centrally managed and controlled outside Hong Kong and have Hong Kong licensed fund managers ("Type II funds" as depicted in Appendix 2).

3. Funds that are centrally managed and controlled in Hong Kong and have Hong Kong licensed fund managers ("Type III funds" as depicted in Appendix 3).

A. NON-RESIDENT REQUIREMENT FOR EXEMPTION

POLICY CONSIDERATIONS

The Exemption Provision of the Bill as currently drafted would appear to cover only Type I and Type II funds.

The Type I fund is a fund that is managed by an overseas fund manager outside Hong Kong on a day-to-day basis. Its central management and control is generally situated in the same location as the overseas fund manager, i.e. outside Hong Kong. As such, the fund would be a non-resident fund and would be exempt under the Bill from taxation on its Hong Kong sourced trading income from specified transactions.

The Type II fund differs from the Type I fund in that a Hong Kong based fund manager (as opposed to an overseas manager) is appointed to operate and make investments on a day-to-day basis.

Under the operational model of the Type II fund, the Hong Kong fund manager is part of a global set-up and belongs to an international fund management group. As such, the fund's central management and control could, if desired, be arranged to be located outside Hong Kong.

It follows that the fund would probably be regarded as a non-resident fund and, therefore, would qualify for the exemption under the Bill.

The Type III fund, on the other hand, would not qualify for the exemption. Although Type II and Type III funds are essentially identical, Type III funds frequently lack the global setup or international network to allow for the fund's central management and control to be located outside Hong Kong. As a result, a Type III fund being a resident fund will not be eligible for the exemption under the Bill despite the fact that its operational presence in Hong Kong may be identical to that of a Type II fund.

Given the operational similarities between Type II and Type III funds, the difference in tax treatment under the Bill begs the question of whether this is an intended policy objective.

It is worth mentioning that the concept of residency has never been used as a condition for determining tax liabilities in Hong Kong. We therefore do not understand the rationale for allowing residency to now bestow a more favourable tax result on Type II funds. From a policy standpoint, we believe distinctions based on residency should be avoided.

Furthermore, we believe certain policy considerations strongly advocate exempting funds which are centrally managed and controlled in Hong Kong, i.e. the Type III funds.

Type III funds often take the form of boutique funds and have become increasingly popular in recent years. An informal review of our client base suggests that about 30% of our client funds are Type III funds. These funds are typically launched by experienced fund managers who gained their expertise and experience by working with Type I or Type II funds. Such managers often decide to venture out on their own and have to forgo the international network of support enjoyed by Type I and II funds. Extending the exemption to Type III funds would help encourage the development of Hong Kong based fund management companies by ensuring such funds are not disadvantaged from a tax perspective. Additionally, an opportunity to manage such funds could be regarded as a career goal by younger managers entering the industry.

In addition, because the central management and control of these funds is in Hong Kong, they are far more likely to purchase products and services in Hong Kong to the wider benefit of Hong Kong's economy. It would be counterproductive if, for the sake of fulfilling the non-resident requirement, activities that would normally be carried out in Hong Kong were diverted overseas artificially or unnecessarily by funds which are operated and managed in Hong Kong on a day-to-day basis.

Lastly, if the non-residency requirement for exemption is removed, there could be an added benefit of encouraging Type I and Type II funds to move their central management and control functions to Hong Kong. This would clearly bring further economic benefits to Hong Kong.

<u>Deeming Provision of the Bill</u>

Further to the above comments, we believe funds should be exempt from tax regardless of their residency.

The possibility of Hong Kong residents abusing or taking advantage of the Exemption Provision should not be a concern because such events can be addressed through the application of the Deeming Provision. Under the Deeming Provision, those residents who abuse the Exemption Provision would fall back into the Hong Kong tax net in respect of income from specified transactions. As such, we submit that there is no need to make the Exemption Provision of the Bill dependent on the non-residency of a fund.

In any case, we submit that the Deeming Provision should not be applicable to resident individuals.

Under the Deeming Provision, any resident investor who has a 30% or more interest in an exempt fund would generally be liable to Hong Kong profits tax in respect of Hong Kong sourced trading income arising from specified transactions. However, as the law now stands, resident individuals are rarely subject to profits tax on similar transactions unless the said individuals are regarded as being closely connected with the securities industry, and, as such, regarded as engaging in securities trading. Given the usual absence of taxation where an individual engages in such securities transactions, subjecting resident individuals to tax under the Deeming Provision in respect of similar income accruing to an investment fund appears unwarranted.

Conversely, resident corporations are currently subject to profits tax on securities trading. We understand that it is the Administration's concern that these resident corporations might take advantage of the Exemption Provision to avoid paying profits tax on such income. Accordingly, we propose that the Deeming Provision only applies to resident corporations and resident individuals having a direct beneficial interest in exempt funds be excluded from it.

Resident individuals who are associated with exempt funds should perhaps remain with the Deeming Provision by reason that they could be regarded as being closely connected with the securities industry.

PRACTICAL CONSIDERATION

Difficulties in determining the location of central management and control

The categorization of funds under Type II may perhaps be an oversimplification where there may be a whole spectrum of sub-categories under it. At one end of the spectrum is Type I funds and the other end is Type III funds.

The common thread of this whole spectrum of funds is the existence of a purported central management and control outside Hong Kong. However, what actually constitutes "central management and control" is uncertain and may therefore create practical difficulties.

In this regard, the Inland Revenue Department have noted that determining the location of the central management and control of a corporate entity is a fact-finding process[2]. Unfortunately, the IRD do not go on to provide guidance as to which facts in particular will be relevant. Furthermore, once the facts have been ascertained, the relative weight to be attributed to each in arriving at an overall decision is unclear. This lack of clarity will be a source of ongoing uncertainty.

The purpose of the Bill is to bring a degree of certainty to the fund management industry as regards the likely tax consequences where there is a Hong Kong connection. We do not believe that this objective can be fully realized where exemption depends on a fund being centrally managed and controlled outside Hong Kong, the term "centrally managed and controlled" lacking a clear definition and its determination being therefore dependent on to a rather subjective fact-finding process.

As such, if our above submission as regards the Exemption Provision is not accepted from a policy consideration standpoint, we would suggest that the Bill should contain a clear and practical definition of the term "resident" to be applied to funds.

B. SPECIFIED TRANSACTIONS

POLICY CONSIDERATION

In order to be eligible for the exemption under the Bill, a non-resident fund must restrict its activities in Hong Kong to the specified transactions and transactions incidental thereto.

However, it may be quite common for hedge funds, as one of their main investment strategy and focus, to be engaged in activities in Hong Kong such as foreign exchange trading and certain commodity and derivative transactions not falling within the definition of the specified transactions. As such, these funds would not be exempt from taxation in Hong Kong in respect of these activities.

We submit that from a policy consideration standpoint the Bill should extend the definition of the specified transactions so as to cover transactions such as those mentioned above that are commonly engaged by funds in Hong Kong.

PRACTICAL CONSIDERATION

From a practical point of view, it may not be clear as to what transactions could be regarded as incidental to the specified transactions. The risk is that, under the Bill, in case a fund undertakes transactions (in addition to the specified transactions) which are not regarded as incidental thereto, the fund would lose its exempt status in respect of the specified transactions.

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[2] DIPN 32, para 66.

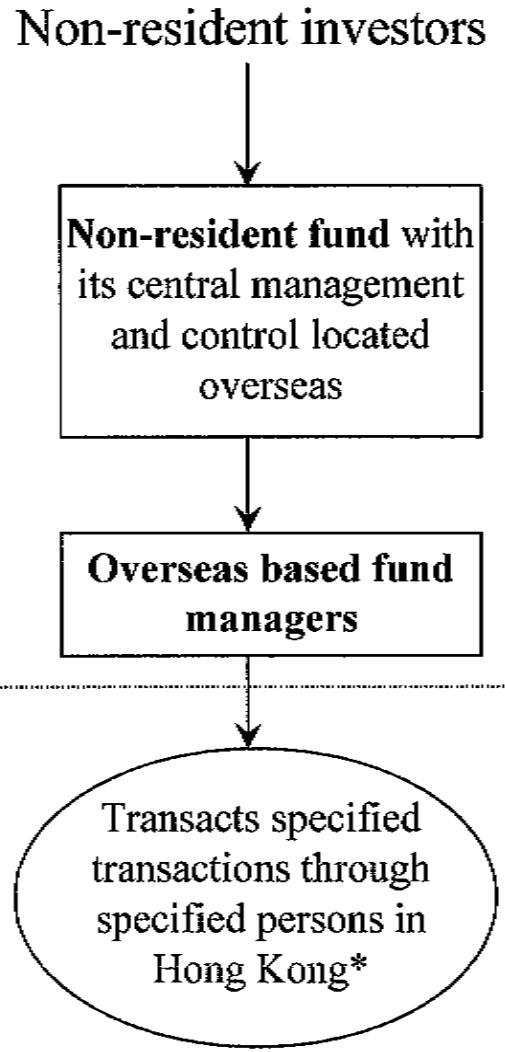
We therefore submit that if our above suggestion of extending the definition of the specified transactions is not accepted from a policy consideration standpoint, the Bill could perhaps deem those transactions that are commonly engaged by funds as being incidental to the specified transactions. As such, the exempt status of the funds in respect of the specified transactions would not be tainted by other common transactions carried out by such funds.

If you have any questions, please feel free to contact us.

Yours faithfully,
For and on behalf of
Ernst & Young Tax Services Limited

Florence Chan
Tax Partner

Encl.



* i.e. dealing in securities, futures contracts and leverage foreign exchange transactions through persons authorized or licensed under the Securities and Futures Ordinance