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**By Fax and Email**

Hon. James Tien Pei-chun, GBS, JP  
Chairman of the Bills Committee  
Legislative Council  
Legislation Council Building  
8 Jackson Road  
Central  
Hong Kong SAR  
The People's Republic of China

13 October 2005

Dear Sirs,

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

We refer to the Invitation for Submissions dated 22 July 2005 issued by the Hon. James Tien Pei-chun, Chairman of the Bills Committee with respect to the Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005 (the "Bill").

PricewaterhouseCoopers ("PwC" or "we") are one of the key professional advisors and service providers to various entities in the investment management industry. We work closely with the key players in the investment management industry and fully understand the importance of the investment management industry to the Hong Kong economy.

We strongly support the Government's determination to reinforce the status of Hong Kong as an international financial centre and asset management centre; and to strengthen the competitiveness of Hong Kong amongst other international financial centres by exempting offshore funds from Hong Kong profits tax on their profits earned in Hong Kong. We believe the Bill is a step in the right direction.

PwC support the enactment of the Bill into law. Nevertheless, we do have a few suggestions which we believe would further improve the Bill. We sincerely hope that the honourable members of your Committee would consider our suggestions and comments and introduce Committee Stage Amendments to the Bill before it is passed to the Second Reading and Third Reading stages.

**EXECUTIVE SUMMARY**

PwC have three main comments on the Bill as follows:-

(1) Definition of "central management and control"

"Non-Residence" is one of the conditions for exemption under the Bill. The Bill states that the residence of corporations, partnerships and trustees of trust estates is where the "central management and control" located. Neither the current Inland

Revenue Ordinance nor the Bill defines the meaning of "central management and control". The Inland Revenue Department stated its view on this matter in paragraph 5 of the Supplementary Notes / Responses to Industry's Concerns ("Supplementary Notes") issued by the Financial Services and the Treasury Bureau on 4 October 2005.

The Supplementary Notes do not form part of the Bill and have no legal binding effect. We suggest a clear definition of "central management and control" be included in the final version of the Bill. Please see section I(1) below.

(2) Attracting the flow of genuine overseas funds into Hong Kong

The scope of the Deeming Provisions (proposed s.20AE refers) is too wide and may have the undesirable effect of taxing Hong Kong conglomerates for profits earned by their overseas subsidiaries / associated companies from investments in Hong Kong securities. We suggest that the Deeming Provisions should not be invoked in cases where the Hong Kong conglomerates can prove to the satisfaction of the Commissioner of Inland Revenue that the profits from trading in Hong Kong securities were earned by the overseas subsidiaries / associated companies by using the latter's own moneys generated from overseas genuine business or from the latter's surplus capital and the Hong Kong parents were not involved in their investment decisions.

(3) Retrospective application of the Bill

We strongly support the retrospective application of the exemption provisions.

## OUR SUBMISSION

Before we set out our concerns and suggestions in detail below, we would provide your Committee with some relevant information about the funds industry in Hong Kong (Appendix 1). We believe it is important to include this information in our submission in order to highlight the value of the investment management industry to the Hong Kong economy and to stress the importance of carefully drafting the Bill to ensure it is effective in achieving the objectives of the Government in relation to the exemption.

### I. MAJOR CONCERNS AND SUGGESTIONS

The Government has indicated its desire to introduce legal provisions capable of providing tax certainty for offshore funds. We have carefully reviewed and considered the proposed provisions contained in the Bill and the explanations and additional information in the Supplementary Notes. We support the Bill and the objectives it seeks to achieve, and in particular welcome the Supplementary Notes which provide valuable clarifications and additional information about the intention of Government and the various provisions of the Bill. We still have a number of comments on the Bill and the Supplementary Notes and would ask that these be taken into account by Government and seriously considered before any final legislation is passed. Our comments are set out below.

**(1) “Central management and control” test**

The Bill proposes using the “central management and control” test to determine the tax residence for corporations, partnerships and trustees of trust estates. The “central management and control” test is not defined in the Bill or the IRO. Paragraph 5 of the Supplementary Notes sets out what the Inland Revenue Department (“IRD”) takes its meaning to be. Paragraph 5 states the IRD considers that:

*“the central management and control of a company refers to the highest level of control of the business of that company”.*

We strongly support this view taken by the IRD. Our concern however is that the Supplementary Notes are not part of the Bill and may not have legal binding effect. To ensure this view is followed and consistently applied in the future, we suggest a Committee Stage Amendment (“CSA”) to the Bill be introduced to give legal binding effect of the above view. We would reiterate that one of the key objectives of the Bill is to provide tax certainty for offshore funds and the consistent interpretation and application of the “central management and control” is vital. The inclusion of this view as part of the law will pre-empt unnecessary disputes and litigations in the future.

**(2) Section 20AE - Assessable profits of non-resident persons regarded as assessable profits of resident persons (the “Deeming Provisions”)**

We support the inclusion of the Deeming Provisions to prevent Hong Kong resident persons from abusing the exemption provisions. The scope of the Deeming Provisions however is too wide and we believe the current provisions in the Bill fetter the flow of genuine overseas moneys into Hong Kong. The Administration does not appear to agree that the Deeming Provisions should not apply to Hong Kong resident companies in situations where such resident corporations have overseas subsidiaries / overseas associated companies which carry on their own business activities completely independently outside of Hong Kong and which may invest their surplus funds derived from those overseas businesses in world-wide securities markets, including Hong Kong. The explanation given by the Administration in paragraphs 31 to 33 of the Supplementary Notes is that administering the Deeming Provisions by reference to the source of funds is impractical and open to abuse.

This view seems inconsistent with the intention of the Administration. The Administration states in the Supplementary Notes that the objective of the Bill is to exempt offshore funds from profits tax liability where they deal in Hong Kong securities. Paragraph 2 of the Supplementary Notes states that: “as a fund is just a sum of money, it is not a taxable entity as such.” That is to say the intention of the Bill is to exempt offshore monies from liability to profits tax where they earned profits from dealing in Hong Kong securities and other prescribed exempt transactions.

The Administration should not refuse exemption for bona fide overseas subsidiaries or associated corporations of resident corporations if they can prove to the satisfaction of the Commissioner of Inland Revenue that the monies are in fact generated from genuine businesses carried on by the overseas subsidiaries or associated corporations outside of Hong Kong and the monies represent surplus capital of the overseas subsidiaries or associated corporations. The Administration should not take an "all or nothing" approach in this instance. It would be both inequitable and excessively penal to seek to invoke the Deeming Provisions and subject resident corporations to tax simply because they are associated with the overseas related companies but did not actually participate in the daily management and treasury functions of the overseas related companies.

We suggest that the Deeming Provisions should not apply to resident corporations with non-resident subsidiaries / non-resident associated corporations where the latter have bona fide active business operations outside Hong Kong or invest their overseas generated surplus capital to carry out the types of transaction mentioned in section 20AC of the Bill through appropriate licensed persons in Hong Kong. Relief from the Deeming Provisions should be available where there is documentary evidence proving that a case falls into the above category.

**(3) Section 70AB - Retrospective application of the Bill**

We strongly support the retrospective application of the exemption provisions.

**II. OTHER CONCERNS**

**(1) Scope of exemption**

We welcome the Administration's decision to revisit whether the scope of qualified transactions is wide enough for the purposes of the proposed exemption and its intention to relax the scope of the exemption to cover the "securities-related activities" engaged in by the industry. The Administration in paragraph 12 of the Supplementary Notes indicates that it will move a CSA to introduce two new schedules to the IRO to expand the scope of qualified transactions and to expand the meaning of "securities" in the context of the Bill if necessary. We also note in paragraph 13 of the Supplementary Notes that the Administration is prepared to move a CSA to expand the scope of specified persons. We are pleased to see the Administration is listening to the industry's concerns and taking action to improve the Bill.

However, we would ask for clarification on one point. Any CSA or new schedule to the IRO should clearly and unambiguously state that income earned by a 'qualifying' offshore fund (i.e. an offshore fund which meets all of the relevant conditions) from transactions carried out through or arranged by an SFC licensed 'specified' person (i.e. a person with any of the Types 1 to 9 licences issued by the SFC) will be exempt, subject of course to the 5% de minimus rule on incidental income. This is our understanding of the situation and clarification on this point will greatly help to provide certainty to offshore funds in relation to the exemption.

**(2) Non-participating management shares**

We are pleased to note in paragraph 23 of the Supplementary Notes that the Administration is prepared to move a CSA to carve out management shares from the application of the Deeming Provisions.

**(3) Schedule 15 - ascertaining the amount of assessable profits of a resident person under Section 20AE**

The formula set out in Schedule 15 for calculating the amount of assessable profits of a resident person imposes onerous information keeping requirements on investment managers, administrators, custodians, etc. ("relevant persons") in relation to the units held in offshore funds. The proposed legislation requires the relevant persons to keep a record of the number of units held in a fund on each day in a given period. This requirement is costly and may not be practical in that most funds only prepare monthly or periodic rather than daily valuations. We suggest that a monthly average formula be used for the number of units or shares.

**(4) Offshore Funds listed in Hong Kong**

Under the current tax legislation, offshore funds listed on the Hong Kong Stock Exchange are not exempt from Hong Kong profits tax. Offshore funds listed in Hong Kong are required to register a branch in Hong Kong. The Bill proposes to exempt offshore funds from tax only if these funds are not carrying on any business in Hong Kong (Section 20AC(5) refers). Our concern is whether the existence of such a branch in Hong Kong could cause the offshore fund be regarded as carrying on business in Hong Kong. If so, they will be denied exemption under the proposed legislation. Instead of penalising these funds, the Government should encourage more overseas funds to become listed in Hong Kong. We suggest the Exemption Provisions should be extended to cover offshore funds listed in Hong Kong.

**(5) "Start-up" Relief**

As discussed in our submission paper dated 31 January 2005, it is common industry practice that in the early phases of an offshore fund's existence, the promoter or investment manager would start up a fund by injecting seed capital to provide prospective investors with an established fund to invest in. This may cause the offshore fund to be regarded as being controlled by the promoter / investment manager in the period before participating investors start investing in the fund.

It would therefore make sense to provide relief in the form of a period of grace from having to meet the "associate" condition stipulated under the Deeming Provisions to new "start-up" offshore funds. This could be similar to the relief the Singapore Government has recently offered there.



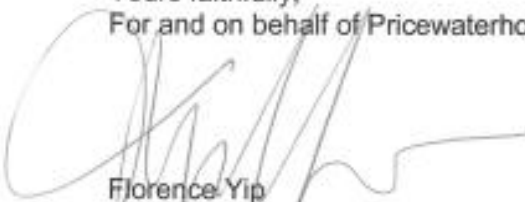
We understand the Administration's policy of excluding shares in private companies from tax exemption in the Bill and its concern that Hong Kong residents might try to abuse the exemption provisions. But we would reiterate the importance of providing some form of capital gain exemption certainty in order to encourage more private equity funds businesses to set up in Hong Kong. This is a rapidly growing area of the industry and the value of its contribution to the Hong Kong economy is expected to increase significantly over the future years.

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We would ask that you carefully consider the above comments before finalising the provisions of the Bill. Our comments highlight genuine concerns with real practical issues likely to arise once this Bill is enacted in to law. We welcome the initiative shown by the Administration in introducing the Bill and discussing its provisions with industry and look forward to the enactment of a comprehensive and effective piece of legislation which will provide a stimulus for growth in the investment management industry in Hong Kong.

We trust you will find the above useful. Should you wish to discuss further with us any of the above comments, please contact the undersigned by telephone on 2289-1833 or by email at [florence.kf.yip@hk.pwc.com](mailto:florence.kf.yip@hk.pwc.com).

Yours faithfully,  
For and on behalf of PricewaterhouseCoopers Ltd.



Florence Yip  
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**A. The Investment Management Industry in Hong Kong**

A recent fund management survey in respect of the year ended 31 December 2004 was published in July 2005 by the Securities and Futures Commission ("SFC") (the Fund Management Activities Survey ("FMAS")). The survey covered the fund management activities of SFC licensed corporations and SFC registered institutions and found that Hong Kong's fund management business (comprising asset management, advisory business and other private banking activities) amounted to HK\$3,618 billion at the end of 2004. This figure represented growth of 23% from 2003. Out of the total HK\$2,741 billion of assets under management ("AUM") by licensed corporations and registered institutions, only 53% (or HK\$1,466 billion) were managed onshore. This highlights the enormous opportunity for growth this industry represents for Hong Kong.

The FMAS also mentioned that in order to develop the expertise of the Hong Kong fund management industry in alternative investments and to attract a critical mass of well-regulated hedge fund managers to Hong Kong, the SFC established a dedicated team in October 2004 to deal with hedge fund manager's licence applications.

The FMAS stated that institutional funds, non-SFC authorised funds and pension funds remained the major types of funds, representing 39%, 24% and 15% of the total AUM of licensed corporations and registered institutions respectively. SFC-authorized funds, private client funds and mandatory provident funds accounted for the remaining 22%. In terms of growth, non-SFC funds registered the largest year-on-year increase of 63%, followed by a 34% rise in mandatory provident funds, 25% in SFC authorised funds, 18% in institutional funds and 8% in pension funds.

It is noticeable from the findings of the FMAS that at the close of 2004, Hong Kong's fund management business represented half (54%) of Hong Kong's stock market capitalization. Employment in the fund management business grew by 12% during 2004 with a total of 17,039 people being employed at the end of the year. The survey did not cover the contribution made by supporting services providers such as lawyers, accountants, administrators, custodians, trustees, banks, IT and corporate services providers, but clearly these also play a very important role in providing efficient and sophisticated infrastructure and support for the fund industry. The housing of such a body of professionals in Hong Kong is obviously significant to Hong Kong's image as a world class financial centre and for its revenue raising measures.

The significant growth of the fund management business in 2004 bears testimony to Hong Kong's increasing success as a platform in the Asia Pacific region in attracting and managing wealth and assets. The investment management industry has a tremendous potential for future growth. The Hong Kong financial services sector is no longer dominated by large financial institutions. Investment management industry has much greater diversity and variety in comparison with

Banking and Insurance which are consolidating industries to achieve scales. We believe the Hong Kong Government has taken a step in the right direction by proposing to exempt non-SFC authorised offshore funds from Hong Kong profits tax and we hope that it will boost the competitiveness of Hong Kong's fund management industry so that it can continue to grow significantly into the future.

## **B. Common features of an investment fund structure**

We briefly describe below the typical relevant features of an offshore fund structure. It is important to understand such features in order to be able to properly analyse the implications of the provisions of the Bill in real life situations.

In a typical offshore fund structure, the investment fund management or advisory company ("Investment Manager") is usually a Hong Kong incorporated company and the fund is established outside of Hong Kong. The Investment Manger or its overseas parent company typically holds "management shares" in the offshore fund for operational reasons so that it can appoint directors to the board of the offshore fund and to enable it to perform certain corporate functions during each period of the fund's life where there are no participating investors in the fund as is required under, for example, Caymans Islands Law. Generally, these management shares do not give the holders the right to participate in any income distributions by the fund – i.e. such management shares are typically "non-participating" shares and give the holders management and legal control rather than rights of distribution of earnings from the fund.

It is also common industry practice for an Investment Manager to start up a fund by injecting seed capital into it to create an established fund and track record to attract prospective investors. The injection of such seed capital generally results in the offshore fund at the initial stage being both legally and economically controlled by the Investment Manager in the early stages of its existence; and this is likely to be the case until the fund "finds its feet" as is sufficiently well established to attract more outside investors.