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The Hon James Tien
Chairman, Bills Committee on
Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005
Legislative Council
Hong Kong Special Administrative Region of the People's Republic of China

Dear Mr Tien,

Draft Bill to exempt offshore funds from Hong Kong profits tax

We would like to thank the Bills Committee for inviting us to comment on the Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005 (the "Bill"), which we have reviewed in light of the Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005 Supplementary Notes / Response to Industry's Concerns, dated October 2005 (the "Supplementary Notes").

As a professional services firm, Deloitte does not view it as our responsibility to question the government's policy decisions, but rather to advise on the consequences of those decisions. On this basis, we have restricted our comments to discussing whether the Bill achieves the government's desired goal of attracting new offshore funds to Hong Kong and encouraging existing funds to continue to invest here.[1]

We believe that legislative change is crucial to attracting the offshore funds industry to Hong Kong. We further believe that the combination of the Bill and Supplementary Notes provides a very workable solution, subject to some minor issues that we have addressed in our attached submission.

We appreciate the opportunity to share our insights in response to the Bill, and hope that you find the comments to be of use. Please do not hesitate to contact either of our people listed below if you would like to discuss our recommendations in more detail.

Yours truly,

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[1] See for example the speech by Mr. Frederick Ma in moving the second reading of the Bill

TABLE OF CONTENTS

SUMMARY OF RECOMMENDATIONS

As mentioned in our cover letter, we believe that the Bill and Supplementary Notes provide a very workable solution to attracting offshore funds to Hong Kong, subject to several issues. Our recommendations in relation to these issues are summarised below.

	Key Issue	Recommendation
1	Definition of "central management and control"	The definition of central management and control should be expanded slightly to emphasise that the relevant issue is determining the entity's highest level of control. Rules and examples should then be incorporated in a DIPN, as suggested in the Supplementary Notes.
2	Broaden the scope of exemption	The definition of "securities" should be amended for tax purposes to exclude the exceptions in the SFO definition and add additional instruments.
3	Undefined terms	The attempt to distinguish between "incidental transactions" and "other business" should be abandoned and instead the Bill should adopt a de minimus threshold for transactions that do not fit within the exemption. The threshold should be set at a rate of 20%.

We have also attached an appendix providing more detailed comments on these issues, together with some comments on other less significant issues (for example, some technical corrections). Finally, for the Committee's convenience, we have attached draft legislative wording at Appendix B that would incorporate many of our recommendations.

We believe that if the key issues listed above were to be addressed, the Bill and Supplementary Notes would provide a very workable solution towards meeting the desired goals of the Bill. Without wanting to detract from the more important issues listed above, we have also summarised below our other, minor, recommendations.

	Minor Issue	Recommendation
4.1	Double taxation for investors	The deeming provision should be amended so as not to apply to profits that are taxable in another jurisdiction.
4.2	Exemption for start-up funds	An exception should be provided for start-up funds such that the deeming provision does not apply to them during their first two years of assessment.
4.3	Technical correction	A provision should be added to the Bill to amalgamate direct and indirect beneficial interests.
4.4	Technical correction	The reference to "associate" in the deeming provision should be amended so that it correctly refers to the appropriate entity.

Each of these recommendations is discussed in more detail in Appendix A.

APPENDIX A – DETAILED COMMENTS

Background and objective of the Bill

Before we can analyse the Bill, it is important to properly understand the Bill's objective, together with the commercial context in which it would operate. As mentioned in our cover letter, the Bill aims to attract offshore funds to Hong Kong. It appears reasonable to assume that attracting offshore funds to Hong Kong means attracting them to invest in Hong Kong markets and to use Hong Kong fund managers / investment advisers, rather than attracting them to establish their legal registration in Hong Kong.

The first question that should be asked is whether funds currently have a tax disincentive against investing in Hong Kong. In order for funds to be subject to profits tax, they must be regarded as carrying on a trade, profession or business in Hong Kong and deriving Hong Kong sourced income from that trade, profession or business.

In our experience, few funds (if any) would directly carry on a trade, profession or business in their own right. Instead, the funds generally engage a dedicated fund manager to manage the fund's investments. The fund manager generally conducts research and negotiates and executes deals for the fund. In some situations, the fund manager provides these services itself. However, in other situations (especially involving larger global funds), the fund manager establishes local investment advisers (e.g., perhaps one in Europe and one in Asia). The investment advisers often conduct local research, advise on local deals and potentially even have the authority to bind the fund by engaging local dealers/brokers to execute trades. Nevertheless, the investment advisers work within parameters set by the investment manager, and are often subject to close supervision and internal controls.

If an offshore fund has no investment manager/adviser in Hong Kong, then the fund is unlikely to be regarded as carrying on a trade, profession or business here. Consequently, the fund should generally not be subject to profits tax even if it derives Hong Kong sourced income. Therefore, there is little disincentive for an offshore fund to invest in Hong Kong markets if it has no local investment manager/adviser.

An issue arises as to whether the fund is subject to tax in Hong Kong when the fund engages an investment manager/adviser in Hong Kong; in which case the manager/adviser can often be regarded as an agent of the fund and thus cause the fund to be regarded as carrying on business in Hong Kong. In this situation, the fund prima facie becomes subject to profits tax on its Hong Kong sourced income.[2] Consequently, offshore funds have a tax disincentive against establishing an onshore investment manager/adviser (or investing in Hong Kong markets if such a manager/adviser is established).

As can be seen from the analysis above, in order to attract offshore funds to invest in Hong Kong markets, the funds must be able to establish dedicated local investment managers/advisers without triggering a profits tax liability.

1. Definition of "central management and control"

One of the key issues in the proposed rules is whether a person is regarded as resident or non-resident of Hong Kong. For entities other than individuals, this issue depends on the interpretation of the phrase "central management and control".

[2] The liability to tax is subject to the fund's income being revenue rather than capital in nature and the fund failing to satisfy the exemption for bona fide widely held funds in section 26A(1A) of the IRO.

The term "central management and control" is familiar in relation to taxation matters, having developed under case law from other common law countries.[3] The cases make it clear that the location of central management and control is imprecise and depends upon the facts of a particular case. Unfortunately, this fluidity in definition is inconsistent with the funds community's desire to obtain certainty of tax treatment.

In order to overcome this uncertainty, we agree with the approach suggested in the Supplementary Notes that rules and examples should be provided in a Departmental Interpretation and Practice Note ("DIPN"). We also suggest that the term "central management and control" be qualified in the legislation to emphasise that the relevant issue is determining the entity's highest level of control.

The following points relate to the wording of the proposed DIPN rather than the provisions of the Bill itself. However, we make the points in this submission as we believe that they would help provide greater certainty in this area.

When developing the guidelines and examples for the DIPN we submit that the authority from Australia should be followed, rather than that from the UK, because the Australian authority provides greater certainty. The Australian Taxation Office's ruling in relation to residence provides some guidelines that could be adopted to provide more certainty in Hong Kong.[4] For example:

- The place where the board of directors meets is a prima facie indicator of where the central management and control is located.[5]
- To provide greater certainty, the Australian Commissioner will accept, as a matter of practical compliance, that the central management and control of a company will be located where the majority of its board meetings take place, provided that the circumstances do not indicate an artificial or contrived outcome.[6]
- Central management and control involves the high level decision making processes, including activities involving high level company matters such as general policies and strategic directions, major agreements and significant financial matters...[7]

2. Definition of "securities"

One of the main types of transaction that qualifies for the exemption under the Bill is "dealing in securities". We understand from the Supplementary Notes that the Administration will consider implementing a broader definition of "securities".

We welcome this broader approach and believe it will assist to meet the goals of the Bill. One potential way to implement the amendments would entail the following:

1. First, amend the definition of "securities" for tax purposes so as to focus on the positive limbs of the definition in the SFO and ignore the exceptions in the definition.

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[3] See Departmental Interpretation and Practice Note (No. 32) at page 25 for a discussion of some of the cases. See for example, De Beers Consolidated Mines v Howe [1906] AC 455; Swedish Central Railway Co v Thompson [1925] AC 495; Koitaki Para Rubber Estates Ltd v FCT (1941) 2 AITR 167; Esquire Nominees Ltd v FCT (1972) 3 ATR 105

[4] Australian Tax Office Public Ruling TR 2004/15

[5] TR 2004/15 at paragraph 49

[6] TR 2004/15 at paragraph 15

[7] TR 2004/15 at paragraph 13

2. Second, add a list of prescribed instruments that would fall within the definition for tax purposes, such as:

    - Interest rate derivatives;
    - Credit derivatives;
    - OTC commodity derivatives;
    - Spot foreign exchange transactions;
    - Borrowing/lending money; and
    - Physical commodity trading.

We note that this approach would have the effect of exempting trading in private company shares. We understand from the Supplementary Notes that one reason against exempting trading in such shares is for integrity purposes; i.e., so as not to grant an exemption for trading in shares of private companies purposely set up for holding particular assets (such as real property). We agree that the exemption should not extend to abusive arrangements such as those cited in relation to the trading of real property. However, we submit that the proposed approach of not granting an exemption for private company shares is not the most effective way to delimit the exemption. This approach has the unintended consequence of potentially denying the exemption to legitimate offshore funds in the private equity industry. It would be more effective and equitable for the rules to allow an exemption for gains arising from the disposal of private company shares as a general rule, while denying the exemption for specified transactions (such as trading in companies the value of whose shares consists principally of real property – a phrase used in numerous countries' domestic law and in many bilateral tax treaties).

3. Incidental activities and other business

The Bill provides no guidance as to whether a transaction would be considered to be "incidental" (in which case it might still qualify for the exemption) or "other business" (in which case the fund would lose the entire exemption for all its transactions).

We understand the concern expressed in the Supplementary Notes about defining "incidental transaction". We agree that the term would be very difficult to define adequately given the different ways in which offshore funds might operate. However, the distinction between "incidental transaction" and "other business" is crucial to the operation of the exemption provision and can cause a fund to lose its entire exemption, even with regard to its transactions that would otherwise clearly be exempt. Given the vastly different consequences that arise based on this distinction, we submit that it is important to provide certainty in this area.

If offshore funds cannot obtain certainty that their transactions would be exempt (or at least that a particular transaction would not disqualify the fund entirely from the exemption), then, based on discussions with our clients, offshore funds would be much less likely to transact through Hong Kong.

Rather than creating complicated tests to draw such a distinction, we believe that it would be far simpler to remove the distinction and instead adopt a "de minimus" exemption. For example, a fund's transactions should be entirely exempt if the non-qualifying transactions do not exceed X% of the qualifying transactions. In contrast, the fund would lose the exemption for a particular year if it were to breach the X% threshold.

With regard to the percentage that should be applied, we believe that the current 5% threshold would be too low for this modified test and would not provide enough certainty,

especially for diversified hedge funds that invest in many types of instruments. Under the Bill as currently drafted, many transactions undertaken by such funds would likely be regarded as non-qualifying transactions. If the fund risked losing its whole exemption by exceeding a mere 5% threshold, we believe that the fund would be much less likely to invest in such instruments in Hong Kong and/or locate its investment adviser in Hong Kong.

We submit that a reasonable threshold to apply in this matter would be a de minimus percentage of 20% of the qualifying transactions. This threshold would provide a compromise between the funds' desire to exempt every type of transaction and the government's apparent desire to exempt only specified transactions. A 20% threshold should provide funds with enough lee-way that they could still invest with flexibility and maintain a degree of certainty that their transactions would be exempt. In contrast, if the threshold were set too high, it would negate the limitations incorporated into the transactions test.

4. Other Issues

4.1 Double taxation due to the deeming provision

In certain circumstances, taxpayers could be subject to double taxation under the deeming provision. We acknowledge the position taken in the Supplementary Notes regarding the double taxation of investors who subsequently dispose of their interest in the fund. However, we are more concerned with an example of double taxation that potentially affects all taxpayers subject to the deeming provision.

Double taxation can arise if the offshore fund derives profits that are exempt under the Bill, but subject to tax in a foreign jurisdiction. In this situation, the resident investor in the fund is subject to Hong Kong and foreign tax on the profits, without any credit or offset for the foreign tax paid.

In order to overcome this inequitable situation, we recommend that the provisions be amended such that the deeming provision should not apply to profits that have been subject to foreign tax. If the government thought it necessary, it could stipulate which countries' taxes would qualify the income for the exemption (e.g., those countries with a minimum tax rate of 15%). Alternatively, it would be possible to eliminate the double taxation by providing a credit for the foreign tax paid. However, we prefer the former approach because a tax credit mechanism would add an unnecessary level of complexity to the already complicated rules.

4.2 Start up funds being caught by the deeming provision

When funds are first founded, they are often capitalised with related party monies while the fund is established and before it is sold to third party investors. At present, the Bill takes no account of this commercial reality and the application of the deeming provision could cause the Hong Kong organisers of start up funds to be fully taxable on the fund's exempt income, thus negating the effect of the exemption while the fund is in its start up phase. Clearly this would have a detrimental effect on attracting new funds to invest in Hong Kong.

In order to remove this deterrent effect, we recommend that the deeming provision not apply to funds in their first two years of operations.

4.3 Technical correction to properly amalgamate direct and indirect interests

As currently drafted, the calculation of attributable profits under the anti-avoidance rule applies if a resident investor has either a direct or indirect interest in the offshore fund. It does not presently amalgamate direct and indirect interests, which could lead to unintended results.

For example, if a resident investor held a 50% direct interest in an offshore fund and also held the other 50% interest indirectly through an interposed entity, the deeming provision would technically only apply to regard the resident investor as having a 50% interest in the fund, even though in substance the investor holds 100% of the fund.

We recommend that an additional section be inserted into Schedule 15 to overcome this matter.

4.4 Technical correction to properly test associate relationships

The deeming provision currently has two operative provisions, one of which is designed to apply to resident investors who have an associate relationship with the offshore fund (the "associate deeming provision"). As currently drafted, the words "non-resident" and "resident" are transposed, which could lead to unintended results.

For example, if an individual resident investor is a director in a corporate offshore fund, this fact alone will not cause the fund to be an associate of the individual and the associate deeming provision will not apply.

We recommend that an amendment be made to the wording in section 20AE(3) to resolve this issue.

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APPENDIX B – DRAFT LEGISLATIVE WORDING

The following draft legislative amendments incorporate many of our recommendations to the Bills Committee. For ease of reference, we have cross referenced the draft amendments to highlight which of our recommendations is relevant to each particular amendment.

Draft legislative amendments	Ref.
[Amend subsection 20AB(2)] 20AB(2) In relation to any year of assessment, a person is to be regarded as a resident person if- ... (*b*) where the person is a corporation that is not a trustee of a trust estate, the central management and control of the corporation <u>being the highest level of control of the company</u> is exercised in Hong Kong in that year of assessment; (*c*) where the person is a partnership that is not a trustee of a trust estate, the central management and control of the partnership <u>being the highest level of control of the partnership</u> is exercised in Hong Kong in that year of assessment; (*d*) where the person is a trustee of a trust estate, the central management and control of the trust estate <u>being the highest level of control of the trust estate</u> is exercised in Hong Kong in that year of assessment.	1
[Amend subsection 20AC(1)] 20AC(1) Subject to subsections (5) ~~and (6)~~, a non-resident person is exempt from tax chargeable under this Part in respect of his profits for any year of assessment commencing on or after 1 April 1996 from- (*a*) transactions falling within subsection (2), (3) or (4) that are carried out in that year of assessment; and (*b*) other transactions carried out in that year of assessment <u>provided that the non-resident person's trading receipts from such transactions do not exceed 20% of the trading receipts from transactions referred to in subsection (1)(a)</u> ~~that are incidental to the carrying out of the transactions referred to in paragraph (*a*)~~.	3
[Insert new subsection 20AC(2)(c)] 20AC(2)(c) for the purposes of applying the definition of "dealing in securities" in subsection 2(a), the term "securities" shall have the meaning within paragraphs (a) to (f) of the definition of "securities" in Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571), and shall also include the following: (i) Interest rate derivatives; (ii) Credit derivatives; (iii) OTC commodity derivatives; (iv) Spot foreign exchange transactions; (v) Deposits and loans; and (vi) Contracts for physical commodities *[Further definitions may be required for items (i) to (vi)]*	2

Draft legislative amendments	Ref.
[Replace section 20AC(5) with the following] 20AC(5) Subsection (1) does not apply to a non-resident person in a year of assessment if, in that year of assessment, his trading receipts from the transactions referred to in subsection (1)(b) exceed 20% of the trading receipts from the transactions referred to in subsection (1)(a).	3
[Delete section 20AC(6)]	3
[Amend subsection 20AE(3)] ... 20AE(3) Where, at any time in the year of assessment in which the Revenue (Profits Tax Exemption for Offshore Funds) Ordinance 2005 (of 2005) commences or in any subsequent year of assessment, a resident person has a direct or indirect beneficial interest in a non-resident person who is exempt from tax under section 20AC and the resident person is an associate of the non-resident person...	4.4
[Insert new subsection 20AE(9)] 20AE(9) Subsection (1) or (3) does not apply in relation to a non-resident person during the non-resident person's first two years of assessment.	4.2
[Re-number existing subsection 20AE(9) to new subsection 20AE(10)]	4.2
[Insert new subsection 20AE(11)] Where (a) the non-resident person derives assessable profits that would have been chargeable to tax under this Part but for section 20AC; and (b) the non-resident person is liable to income tax in a foreign jurisdiction in respect of an amount of those assessable profits; then for the purpose of subsection (1) and (3), the non-resident's assessable profits shall be regarded not to include the amount of assessable profits in relation to which the non-resident is liable to income tax in a foreign jurisdiction.	4.1
[Re-number existing subsection 20AE(10) to new subsection 20AE(12)]	4.1& 4.2
[Re-number existing subsection 20AE(11) to new subsection 20AE(13)]	4.1& 4.2
[Insert new section 4 in Part 2 to Schedule 15] 4. Where a resident person has both a direct and an indirect beneficial interest in a non-resident person, then the extent of the beneficial interest of the resident person in the non-resident person is the sum of those direct and indirect interests as calculated under this Part."	4.3