LC Paper No. CB(1)2078/04-05(01) (Revised)

For Members of LegCo:

Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005

15 July 2005

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Why we need the Exemption

- Maintain HK's competitiveness as major international financial centre
- Most financial centres exempt offshore funds from tax
- Attract/retain foreign capital
- Boost asset management industry
- Benefit downstream services

Tax Treatment of Offshore Funds in Other Jurisdictions

- UK – Exempts offshore fund if it is non-resident and does not have a representative in the UK
- US – Exempts offshore fund set up in certain specified locations (eg, Bermuda, Cayman Islands) not subject to registration requirements of US Securities & Exchange Commission and not offered to US residents
- Singapore – Exempts offshore fund if it is not a Singapore citizen or resident and at least 80% interest of the fund is owned by foreign investors

Consultations Held

- Two rounds of consultation held–
  - Jan 2004
  - Dec 2004

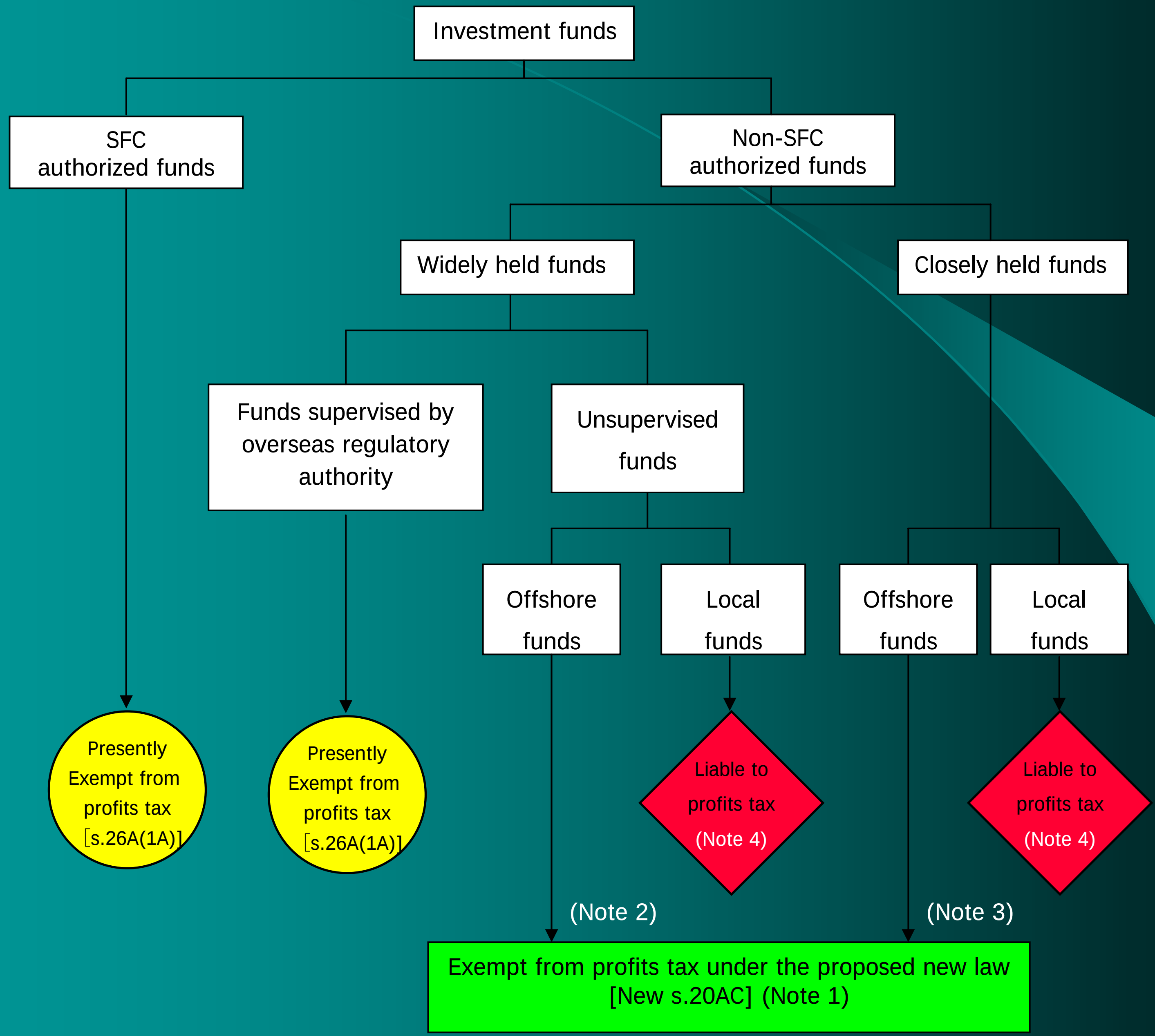
Jan 2004 Consultation

- Proposed model:
  - Minimum 80% foreign investment required (i.e. the Singapore approach)
  - Offshore funds must not be an associate of HK fund managers
  - Fund managers required to keep records
- Industry responses:
  - Onerous compliance burden and costs
  - Unable to trace ultimate beneficial owners
  - High admin. cost in keeping records

Dec 2004 Consultation

- Present model proposed based on residence of the fund only; generally welcomed by industry
- Modified to adopt comments/suggestions:
  - Abandoned % of foreign investor as condition for exemption
  - Scope expanded (futures, forex, incidental transactions added)
  - Associate and independence tests removed
  - Specific record-keeping not required

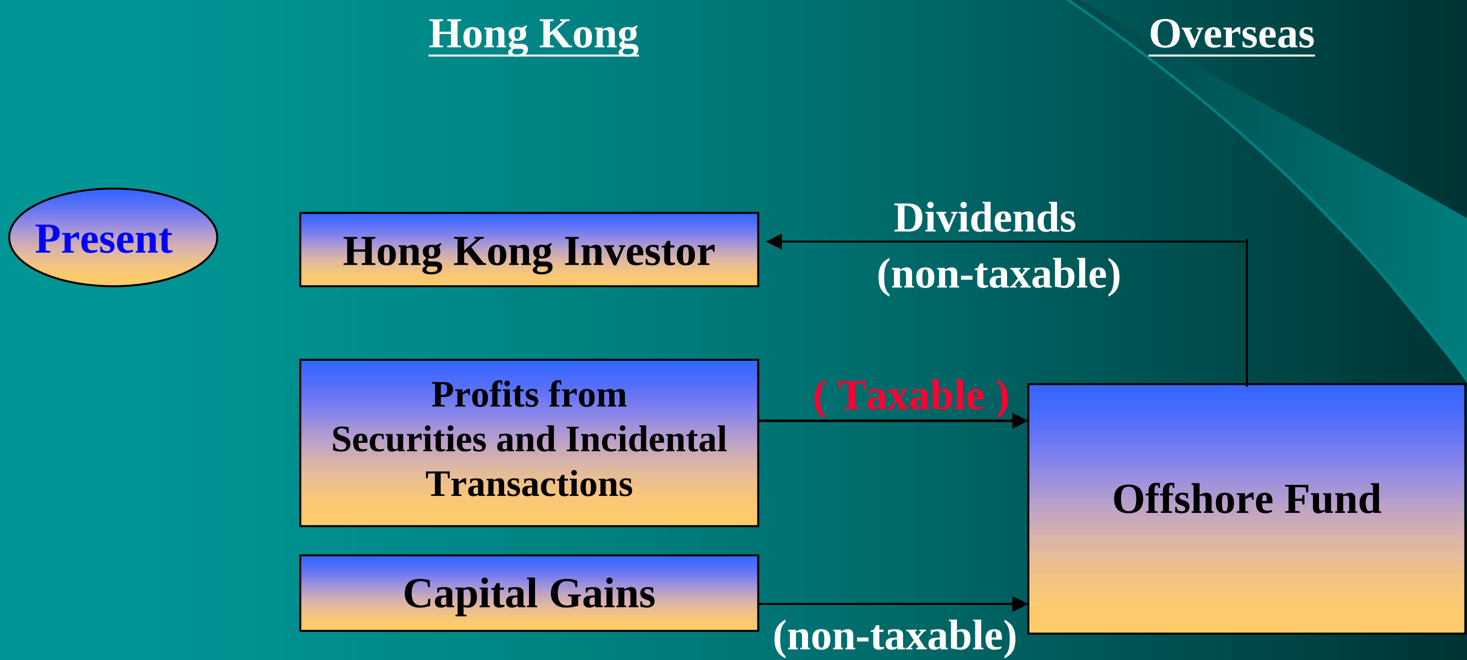
Scope of exemption -1



Scope of exemption - 2

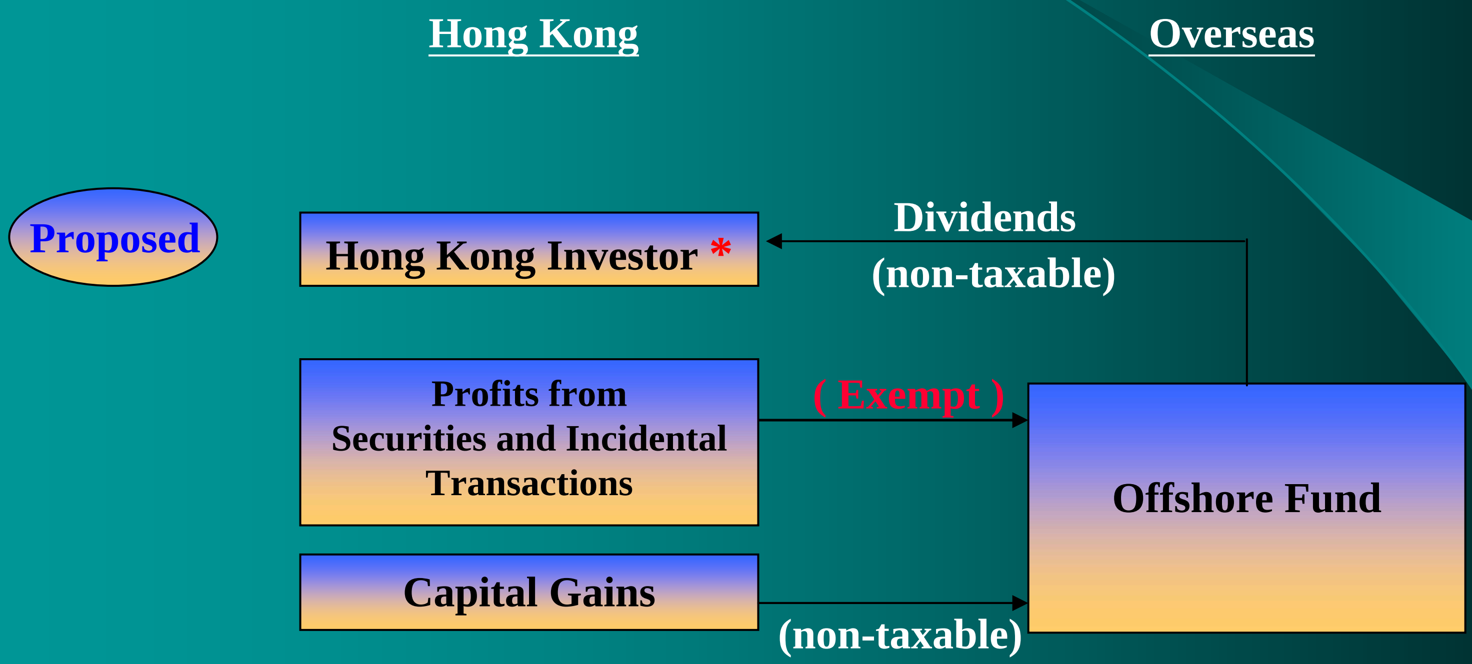
- **Note 1 :** Under the proposed new law, all offshore funds that are currently liable to profits tax will be fully exempt from such tax.
- **Note 2 :** If the offshore fund is widely held, the Deeming Provisions will not apply.
- **Note 3 :** If the offshore fund is closely held, the Deeming Provisions may apply.
- **Note 4 :** Under the proposed law, only those local funds that are closely held [or widely held but not supervised by an overseas regulatory authority] are liable to profits tax. Since they are resident in Hong Kong and carry on securities trading in Hong Kong, they should pay local tax. This is a common international practice.

The Scheme - 1



Hong Kong
Overseas
Present
Hong Kong Investor
Dividends
(non-taxable)
Profits from Securities and Incidental Transactions
(Taxable)
Offshore Fund
Capital Gains
(non-taxable)

The Scheme - 2



* To prevent round tripping, if Hong Kong Investor holds 30% or more interest [or any percentage if the Offshore Fund is Hong Kong Investor's associate], a proportionate part of the Offshore Fund's profits from securities and incidental transactions will be deemed to be the Hong Kong Investor's profits and assessed accordingly.

Exemption Provisions – 1 [Fund Level]

- A fund will be exempted from tax liability if the following 2 conditions are satisfied -
  - Non-resident
  - Has no other business in HK
- The exemption applies to profits from "qualified transactions" carried out by "specified persons" in HK

Exemption Provisions - 2

- Resident person
  - Individual – ordinarily resides in HK or stays in HK for more than 180 days in the year of assessment or 300 days in 2 years one of which is the year in question
  - Partnership, company, trustee of a trust estate – central management and control* is exercised in HK
  - "Central management and control" – common law principle adopted in many jurisdictions in determining residence of companies or other entities
- Non-resident person
  - A person who is not a resident person

Exemption Provisions - 3

- "Qualified transactions" include –
  - Dealing in securities (incl. shares, debentures, funds, bonds, notes, options, warrants, etc)
  - Dealing in futures contracts
  - Leveraged foreign exchange trading
  - Incidental transactions (e.g. stock borrowing and lending), subject to a 5% de minimis rule
  - De minimis rule – if trading receipts from incidental transactions exceed 5% of total trading receipts, trading receipts from incidental transactions are taxable; however, exemption to profits on other qualified transactions not affected
- "Specified persons" include -
  - Corporations and authorized financial institutions that are licensed or registered under the Securities and Futures Ordinance (e.g. stock brokers, fund managers, licensed banks)

Exemption Provisions - 4

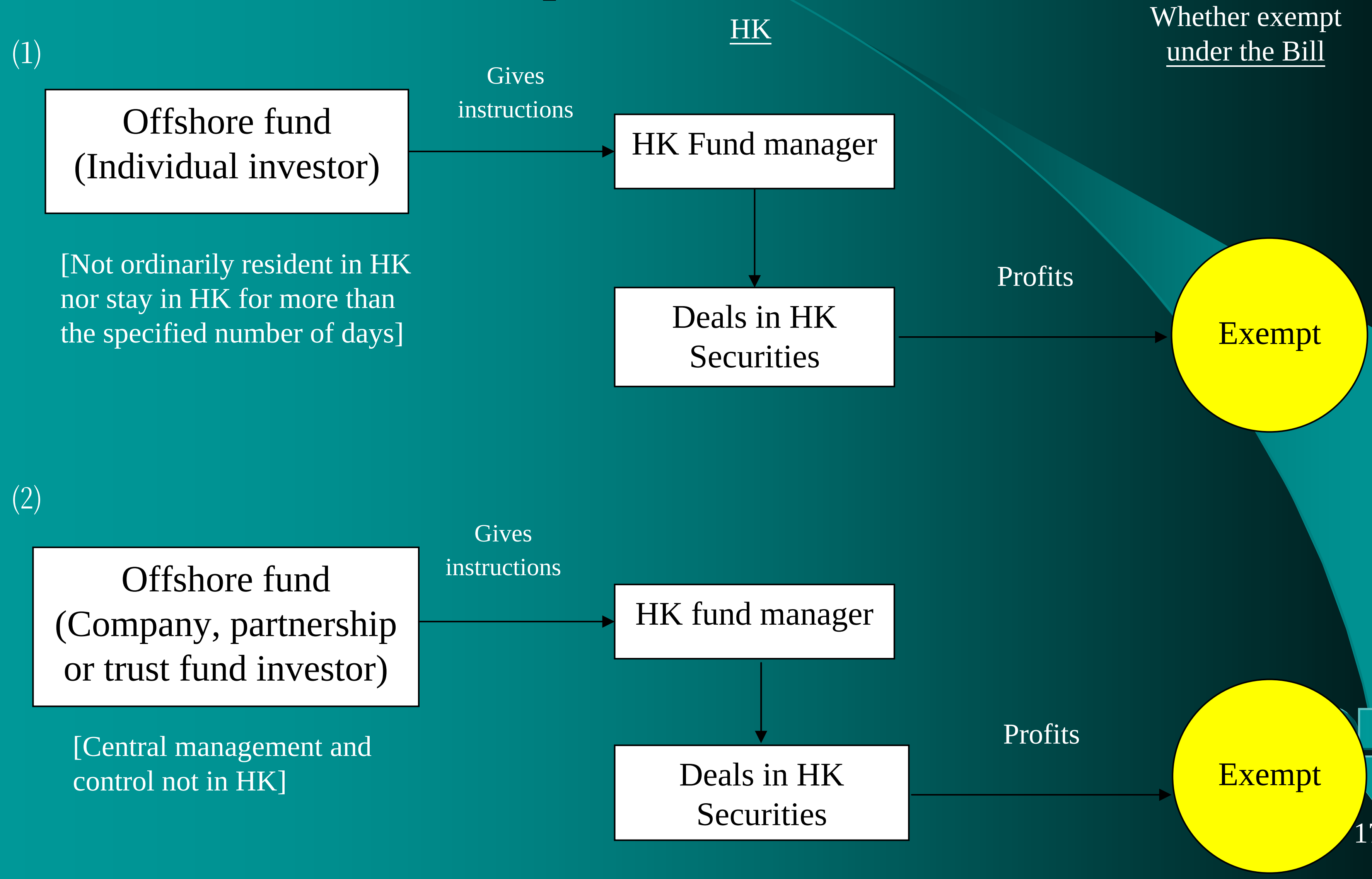
- Exemption proposed to apply retrospectively to year of assessment 1996-97
  - Much called for by industry, otherwise uncertain on tax liabilities of offshore funds
  - IRD is duty bound to assess and collect tax in accordance with provisions of the IRO
- Background
  - In the past, IRD has practical difficulties in taxing offshore funds
  - Provisions under Stamp Duty Ordinance on stock borrowing and lending enacted
  - IRD could therefore obtain information on securities dealings by offshore funds

Exemption Provisions - 5

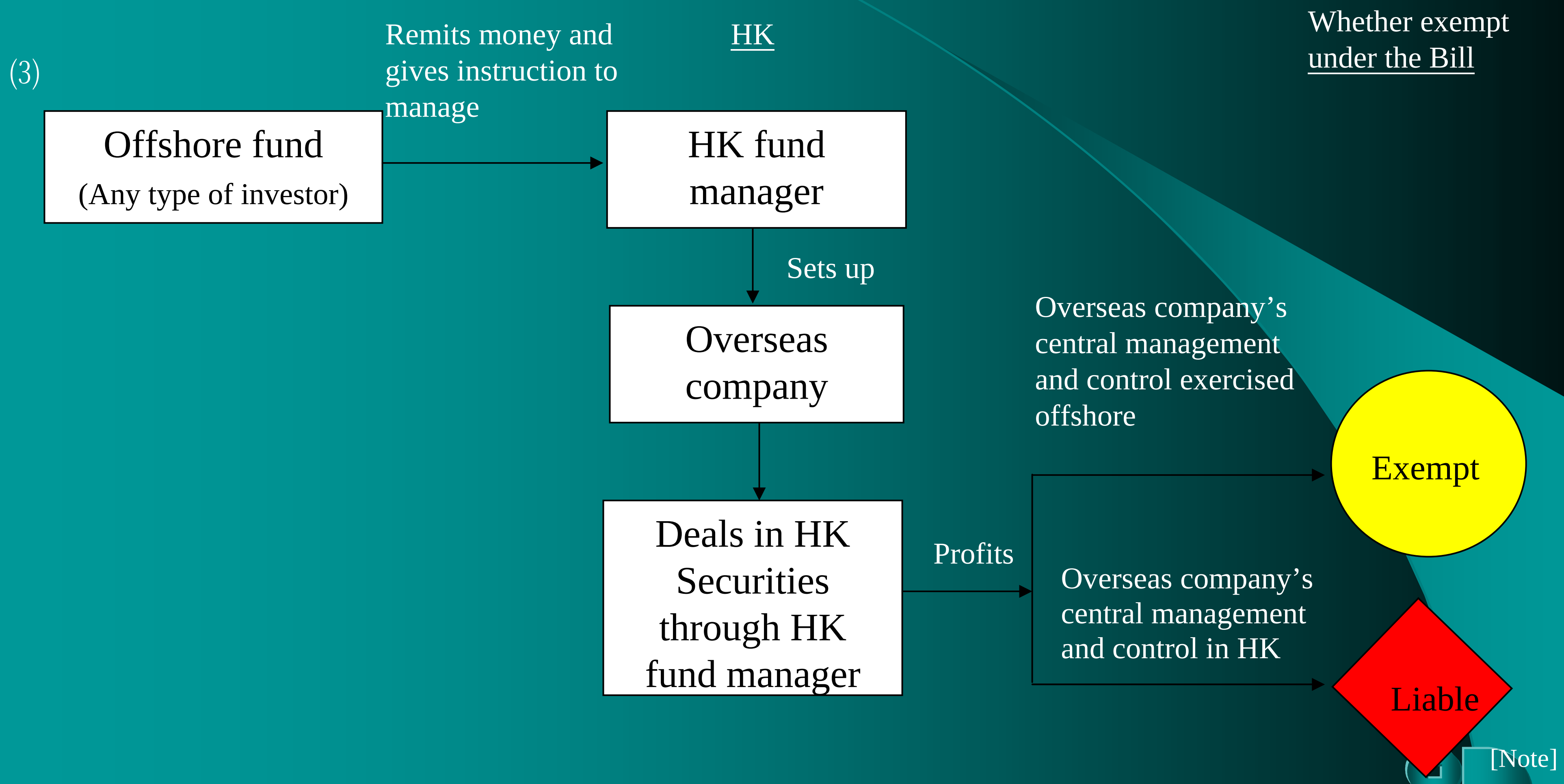
- In 2000, IRD issued returns to offshore funds for 1996-97 onwards
- Aroused concern about taxation of offshore funds

- **Notable examples for tax concession taking retrospective effect -**
  - 1992 shipping income exemption retrospective to 1990
  - 2004 home loan interest and self-education expenses deductions retrospective to 1998/99 and 2000/01 respectively

Examples – Part 1



Examples – Part 2



Note: Since the central management and control of the overseas company is exercised in HK, it has effectively become a local company. Therefore, the profits tax exemption is not applicable.

Deeming Provisions – 1 [Funds Investor Level]

- Why necessary –
  - To prevent round-tripping, i.e. closely held onshore funds disguised as offshore funds
  - By round-tripping, tax properly chargeable on securities trading profits of onshore funds would be avoided
  - Closely held onshore funds are controlled by a few persons only; round-tripping can be easily arranged

Deeming Provisions - 2

- Other similar deeming provisions in IRO -
  - Section 9A : Disguised employment cases
- Deeming provisions in other jurisdictions -
  - Controlled foreign company (CFC) rules in UK, US and Australia (e.g. a UK resident is chargeable to tax on undistributed income of a CFC in which he has an interest of at least 25%, if CFC is in a low tax jurisdiction)

Deeming Provisions - 3

- Operation of the provisions
  - where an offshore fund is exempt from tax on Hong Kong securities trading and incidental profits; and
  - a resident holds 30% or more interest in the offshore fund [or any percentage if the offshore fund is "associate" of local investor]; then
  - a proportionate part of the profits made by offshore fund is deemed to be profits of the resident and assessed accordingly.
  - Only apply to resident investors; exemption of offshore funds not affected

Deeming Provisions - 4

- Why not use the general anti-avoidance provisions under s.61A?
  - Deeming provisions provide more certainty (2 objective tests only - "threshold" and "associate", vis-à-vis the "7-factor test")
  - Difficult to apply s.61A to attribute tax liability to the resident who obtains the tax benefit, in the absence of an express provision providing for such liability
  - IRO already provides framework for any person with tax liability to notify chargeability and to file correct tax return
  - Deeming provisions more equitable and effective for tax recovery purposes

Deeming Provisions - 5

- Why set threshold at 30%?
  - Balance between tax compliance and revenue protection
    - Threshold too low: Residents not in a position to get information from offshore funds to comply with reporting requirements
    - Threshold too high: Easier for residents to avoid tax
  - Industry consulted and considered workable
  - Made reference to CFC rules in other jurisdictions:
    - UK – 25%; US and Australia – 10%
  - HK threshold more favourable than Singapore
    - In Singapore, no exemption to entire fund if exceeds 20% threshold.
    - In HK, offshore fund always exempted and only resident investors taxed if holding exceeds 30% threshold

Effects of Deeming Provisions

- Deter HK residents from carrying out round-tripping
- Promote/attract real foreign capital into HK
- More certainty and easier to comply than existing general anti-avoidance provisions

Concluding Remarks

- The proposed Bill is competitive, clear and easy to comply with -
  - Competitive
    - Exempts all offshore funds
    - Simply based on residence
  - Clear
    - Clear definition of “resident person” and “non-resident person”
    - Clear conditions for enjoying the exemption
    - Clear and easy to understand anti-avoidance provisions
  - Easy to comply with
    - Easy for relevant persons to understand their tax liability and hence easy to comply with relevant provisions

Thank you