

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

Summary of submissions
(Position as at 21 October 2005)

| | <u>LC Paper No.</u> |
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| Capital Markets Tax Committee of Asia (CMTCA) | CB(1)44/05-06(01) |
| British Chamber of Commerce in Hong Kong (BCC) | CB(1)44/05-06(02) (Revised) |
| Clifford Chance (Clifford) | CB(1)44/05-06(03) |
| Hong Kong Society of Financial Analysts Limited (HKSFAL) | CB(1)44/05-06(04) |
| Ernst & Young Tax Services Limited (Ernst & Young) | CB(1)44/05-06(05) |
| PricewaterhouseCoopers Ltd. (PWC) | CB(1)44/05-06(06) |
| Deloitte Touche Tohmatsu (DTT) | CB(1)44/05-06(08) |
| Hong Kong Investment Funds Association (HKIFA) | CB(1)44/05-06(09) |
| KPMG Tax Limited (KPMG) | CB(1)44/05-06(10) |
| The Taxation Institute of Hong Kong (TIHK) | CB(1)44/05-06(11) |
| The Alternative Investment Management Association Limited, Hong Kong Chapter (AIMA) | CB(1)44/05-06(12) |
| The Hong Kong General Chamber of Commerce (HKGCC) | CB(1)44/05-06(13) |
| CPA Australia, Hong Kong China Division (CPA) | CB(1)44/05-06(14) |
| The Law Society of Hong Kong (LSHK) | CB(1)44/05-06(15) |
| The Association of Chartered Certified Accountants (Hong Kong) (ACCA) | CB(1)44/05-06(16) |
| Hong Kong Venture Capital and Private Equity Association Ltd (HKVCA) | CB(1)44/05-06(17) |

LC Paper No.

The Hong Kong Association of Banks (HKAB)

CB(1)44/05-06(18)

Mr David GUNSON (Gunson)

CB(1)44/05-06(19)
& (20)

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ABBREVIATIONS

| | |
|------------------------|--|
| CIS | Collective Investment Scheme |
| CSA | Committee Stage amendment |
| DIPN | Departmental Interpretation Practice Note |
| IRD | Inland Revenue Department |
| IRO | Inland Revenue Ordinance (Cap. 112) |
| SFC | Securities and Futures Commissions |
| SFO | Securities and Futures Ordinance (Cap. 571) |
| Supplementary Notes | Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005 Supplementary Notes / Responses to Industry's Concerns (Appendix 1 to LC Paper No. CB(1)44/05-06(22)) |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
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| 1 | <i>General comments</i> | |
| 1.1 | <ul style="list-style-type: none"> ● Supports the Bill. ● It is believed that the explicit exemption of offshore funds from Hong Kong profits tax will bring Hong Kong in line with other major international financial centres, provide legislative clarity and certainty, promote and retain the fund management industry in Hong Kong. | CMTCA DTT KPMG HKAB |
| 1.2 | <p>Strongly welcomes the Bill on the following grounds:</p> <ul style="list-style-type: none"> ● The Bill will give effect to the IRD’s statement of practice that “...it would be unusual for the transactions of a non-resident through a broker or investment adviser to amount, in themselves, to the carrying on of a trade, profession or business.” (Paragraph 5 of IRD’s Practice Note No. 30: Profits Tax: section 20AA - Persons not Treated as Agents). There is concern that in recent years there have been some moves by the IRD not to follow the stated practice with the attempt to tax some foreign CISs; ● There is a need to provide legal certainty of exemption as under the current law there is a technical risk of Hong Kong tax for certain foreign investors. Countries such as Singapore, the United Kingdom and the United States already provided this legal certainty of exemption. Not having such certainty would put Hong Kong at a significant disadvantage, particularly in relation to the nearest competitor, Singapore. | HKIFA |
| 1.3 | <p>Strongly supports 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 by exempting offshore funds from Hong Kong profits tax on their profits earned in Hong Kong.</p> | PWC HKVCA HKGCC |

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| 1.4 | <ul style="list-style-type: none"> ● Welcomes the Administration’s intention to promote the investment fund industry and shares the view that the proposed legislation will bring positive results to the economy of Hong Kong. ● The growth of the industry in Hong Kong has been sustained over recent years in the face of concerns over the potential tax issue. The industry has taken comfort in the very strong assurances that have been given by the Administration that the issue would be addressed. It is important that those assurances are now carried into effect. ● Urges that legislation should be introduced to facilitate the incorporation of open-ended investment companies in Hong Kong as soon as possible and that the exemption should apply to any bona fide CIS as defined in the SFO, whether established in Hong Kong or elsewhere, rather than limiting the exemption to “offshore” funds. | AIMA |
| 1.5 | <p>The Bill has achieved the purpose of providing profits tax exemption for offshore funds. But it has failed to encourage the growth of funds management industry in Hong Kong.</p> | TIHK Clifford |
| 1.6 | <ul style="list-style-type: none"> ● The Bill would not achieve the objective of attracting funds to Hong Kong due to the narrow scope of the exemption. ● If the exemption was to be enacted in its current form, there is risk that offshore funds would be forced to relocate their investment managers to Singapore or other jurisdictions. | CPA |
| 1.7 | <ul style="list-style-type: none"> ● Expresses concern that the current proposals as contained in the Bill would tend to discourage a large number of new, or existing, boutique fund managers from operating in Hong Kong. ● Owing to the importance of the funds industry to the healthy functioning of Hong Kong’s capital market, the Administration should not rush to pass the Bill. | BCC |

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| 1.8 | The Bill is premature, inadequate and ought to be shelved pending further study on overseas experience and input from the private sector. | Gunson |
| 1.9 | Expresses no comment on the Bill. | LSHK |
| 2 | <i>Clause 2 – proposed section 20AB – Interpretation of sections 20AC, 20AD and 20AE and Schedule 15</i> | |
| <i>Concepts of “resident” and “non-resident”</i> | | |
| 2.1 | <ul style="list-style-type: none"> ● Questions the rationale for using “residency” as a condition for determining tax liabilities under the Bill. ● Suggests that funds should be exempted from tax regardless of their residency. There is no need to make the exemption provisions dependent on the non-residency of a fund. | Ernst & Young |
| 2.2 | <ul style="list-style-type: none"> ● The concept of residence does not sit well with the territorial concept of taxation. The Administration should minimize invoking this concept in the Bill. There are three points of concern or suggestions: <ul style="list-style-type: none"> (a) Determining the residence of a person is fraught with practical difficulties and uncertainties as it depends on the particular fact of each case and quite often each factor has to be subjectively weighted. (b) If an onshore/offshore distinction has to be made, in order to qualify for exemption, a fund must be able to satisfy a more straight-forward and objective test which is consistently applied. Only pertinent factors such as the place of incorporation (if the fund is a corporate vehicle) and the place where the management decision is made should be used to determine the residence of a fund. (c) The IRD should consider issuing a standard questionnaire for determining residence of offshore funds to provide certainty in the | TIHK Clifford |

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| | application of an otherwise highly subjective test. | |
| 2.3 | Expresses concern that the Bill would imply a change of taxation regime from a source-based to a residency-based regime. | Gunson |
| 2.4 | <ul style="list-style-type: none"> ● Under Hong Kong’s current system of taxation, Profits Tax is not levied based on whether a person is a resident of Hong Kong. As such, the IRO contains no legislative definition of the term and there is no case law dealing with the term within the context of the Ordinance. ● As the operation of the exemption requires the person to be a “non-resident” and given that the term “resident” is rarely used under the profits tax regime in Hong Kong, there is concern that if there is no clear interpretation of the term, many offshore funds that are managed from Hong Kong may not fall within the ambit of the proposed exemption. | KPMG |
| 2.5 | <ul style="list-style-type: none"> ● A key requirement of the exemption is that the foreign investor must be a “non-resident”. It is vital that “non-resident” is not defined narrowly, or interpreted narrowly in practice, otherwise it will render the exemption provision ineffective. ● An area of uncertainty is the definition of non-resident person in section 20AB(3). Under the provision, a person is a non-resident person if he is not a resident person defined under section 20AB(2). A resident person can be a natural person who ordinarily resides in Hong Kong or stays in Hong Kong for certain number of days; or a corporation, a partnership or a trustee of a trust estate that exercises its central management and control in Hong Kong. | HKIFA |
| 2.6 | <ul style="list-style-type: none"> ● Under the proposed subsection 20AB(2)(a)(ii), an individual investor leaving Hong Kong permanently in the middle of a year of assessment may be considered as a tax resident for a full year for (a) that year of assessment; and (b) the year of assessment following the year he left. This can be | ACCA |

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| | <p>illustrated by the following examples:</p> <p>(a) An individual left Hong Kong permanently on 1 October 2005. As he ordinarily resided in Hong Kong for 183 days in the year of assessment 2005/06, by the definition of “resident”, he is a tax resident for the full year for the year of assessment 2005/06.</p> <p>(b) An individual left Hong Kong permanently on 1 March 2005, he therefore ordinarily resided in Hong Kong for 334 days in the year of assessment 2004/05. By the definition of “resident”, he could be regarded as tax resident in the year of assessment 2005/06 as he ordinarily resided in Hong Kong for over 300 days in two consecutive years and 2005/06 could be taken as the second of the consecutive year.</p> <ul style="list-style-type: none"> ● The individual investor in example (b) above will be taxed accordingly if he invests in any offshore funds in the year subsequent to that when he left Hong Kong, which apparently is an unfair tax treatment. ● According to paragraph 10 of the Administration’s Supplementary Notes, the residence status of a fund can be determined by reference to the respective periods during which the fund is or is not resident in Hong Kong where the fund changes its residence status during a year of assessment, i.e. split year residence is allowed for a fund. ● It is considered that section 20AB(2)(a)(ii) is disadvantageous to individual investors as investor would be by definition of “resident” not be allowed split year residence. | |

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| 2.7 | <ul style="list-style-type: none"> ● The concept of “split year residence”, as referred to the Administration’s Supplementary Notes is not a concept familiar to the Hong Kong taxation system. ● Clarification of how this would work in practice should be given. For example, whether a fund would be taxable on only profits made during the period of its residence if it becomes “resident” in Hong Kong during the year. | BCC |
| <i>Concept of central management and control</i> | | |
| 2.8 | <ul style="list-style-type: none"> ● The term “non-resident” as used in the Bill refers to those entities whose “central management and control” is exercised outside Hong Kong. There are two points of concern: <ul style="list-style-type: none"> (a) The exemption provisions would appear to cover only the following types of funds - <ul style="list-style-type: none"> (i) Funds that are centrally managed and controlled outside Hong Kong (i.e. managed by an overseas fund manager outside Hong Kong the central management and control is generally situated in the same location as the overseas fund manager). (ii) Funds that are centrally managed and controlled outside Hong Kong and have Hong Kong licensed fund managers (i.e. instead of an overseas fund manager, a Hong Kong based manager is appointed to operate and make investments for the fund on a day-to-day basis, who is regarded as part of a global set-up and belongs to an international fund management group. As such, the central management and control is located outside Hong Kong). (b) Funds that are centrally managed and controlled in Hong Kong and have Hong Kong licensed fund managers will not be eligible for | Ernst & Young |

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| | <p>exemption under the Bill despite the fact that their operational presence in Hong Kong may be identical to those funds mentioned in item (a)(ii) above. The difference in tax treatment for these types of fund gives rise to the question of whether this is an intended policy objective.</p> <ul style="list-style-type: none"> ● Strongly advocates extending the proposed exemption to funds that are centrally managed and controlled in Hong Kong for the following reasons - <ul style="list-style-type: none"> (a) Such funds often take the form of boutique funds and have become increasingly popular in recent years. (b) The exemption would encourage the development of Hong Kong based funds companies, help retain Hong Kong licensed fund managers who have gained their expertise and experience by working for offshore funds, as well as encourage the relocation of offshore funds' central management and control functions to Hong Kong, thus bringing economic benefits to Hong Kong. | |
| 2.9 | <ul style="list-style-type: none"> ● The term “central management and control” lacks a clear definition and its determination is dependent on a subjective fact-finding process by IRD. There is a lack of guidance on the facts and their relative weights which are relevant to the concept. ● The Bill should contain a clear and practical definition of the term “resident” to be applied to funds. | Ernst & Young |
| 2.10 | <ul style="list-style-type: none"> ● It is vital for the growing and evolving investment management industry that Hong Kong implement a system whereby offshore funds managed or advised on in Hong Kong are not subject to tax on profits derived from trading in Hong Kong securities so as to enhance competitiveness of the Hong Kong based funds vis-à-vis those in other markets. | HKSFAL |

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| | <ul style="list-style-type: none"> ● The Administration’s current proposal would only benefit those investment advisers who are part of a global group, whereby it could be shown that control of the business existed in a jurisdiction outside Hong Kong. There are two points of concern: <ul style="list-style-type: none"> (a) A very important part of Hong Kong’s investment industry is founded by local Hong Kong people, with the vast majority of the operations existing within Hong Kong. The Administration’s proposal would put local firms, which are crucial suppliers of stable and high paying jobs, at a disadvantaged position to overseas firms. (b) It would also seriously cripple Hong Kong’s position as a leader in the global financial industry. | |
| 2.11 | <ul style="list-style-type: none"> ● The determination of an entity’s “central management and control” which is dependent on facts of a particular case is imprecise. To overcome the uncertainty due to the fluidity in the definition of the term, the definition should be expanded to emphasize that the relevant issue is determining the entity’s highest level of control (please see the proposed legislative wordings in Ref. 1 in Appendix A). ● Rules and examples of interpretation of “central management and control” should be provided in IRD’s DIPN. In developing the DIPN, reference should be made to the Australian Tax Office Public Ruling TR 2004/15. For example: <ul style="list-style-type: none"> (a) The place where the board of directors meets is a prima facie indicator of where the central management and control is located. (b) 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 | DTT |

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| | <p>located where the majority of its board meetings take place, provided that the circumstances do not indicate an artificial or contrived outcome.</p> <p>(c) 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.</p> | |
| 2.12 | <ul style="list-style-type: none"> ● The central management and control test adds complexity and uncertainty to the territorial taxation system in Hong Kong, and will in practice result in the need for complicated fact-finding. ● Examples 7 and 8 in Annex A of the Administration’s Supplementary Notes epitomises the problems with the proposal. This would discourage boutique funds to set up in Hong Kong. There are many boutique funds in Hong Kong. They should be able to benefit from the exemption. ● The central management and control test will either invite funds to create an unnecessary arrangement to circumvent the limitations in the example 7 or discourage funds from employing Hong Kong-based funds managers, or relocating fund managers from Hong Kong, which defeats the purpose of the Bill. ● The definition of central management and control test, if implemented, should adopt the international norms. Reference should be made to the UK tax case law in this area, UK Inland Revenue Statement of Practice, the Australian case law and Taxation Ruling (ATO- Taxation Ruling 2004/15. | BCC |
| 2.13 | The IRD should issue a practice note specifying the application of the “central management and control” tests. | TIHK Clifford |

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| 2.14 | <ul style="list-style-type: none"> ● The proposed section 20AB(2)(b) adopts the traditional concept of “central management and control” in determining the residence of a corporation. There is concern that in where the location of the actual management of the daily activities is taken into account, the Bill will become ineffective in practice, as the daily operations of the offshore fund are managed in Hong Kong where the fund manager is situated in Hong Kong. ● Welcomes the Administration’s Supplementary Notes that the IRD will incorporate examples in a DIPN to clarify issues in determining the “location of central management and control”. | ACCA |
| 2.15 | <ul style="list-style-type: none"> ● Supports the view of the Administration’s Supplementary Notes that “the central management and control” of a company refers to the highest level of control of the business of that company. ● Expresses concern that the term “central management and control” is not defined in the IRO or the Bill. Therefore suggests a CSA be made to incorporate the proposed definition. ● It is helpful to have clarification that the IRD will look to the composition of the board of a corporate investment fund and where the board meets in determining residence of the fund. | AIMA CMTCA AIMA |
| 2.16 | <ul style="list-style-type: none"> ● The place of “central management and control” should be defined as the place where highest level decisions are made covering general policy, strategic direction, major agreements and financial matters, and reviewing overall performance. Suggests including such definition in the Bill. ● The legislative approach is preferred to the Administration’s proposal to make a statement by way of a DIPN in providing more certainty as a practice note has no legal force. | HKIFA |

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| 2.17 | <ul style="list-style-type: none"> ● The concept of “central management and control” is key to the definition of the term residence. It is crucial that the proposed legislation is enacted with a clear interpretation of the concept either by way of legislation or DIPN. A clear interpretation is necessary to mitigate any potential confusion or disputes in the application of exemption. ● The IRD acknowledges that the place of directors’ meetings is significant insofar as those meetings constitute the medium through which central management and control is exercised. Hence, depending on the specific factual circumstances, central management and control may reside where the board of directors of a company meets to make the high-level decisions about the strategic management and control of the business. ● In order for the exemption to operate effectively, it is proposed that residency of an entity should be based on a central management and control test that considers the location of the entity/fund’s board meetings as being the influential factor in determining residency. ● An alternative for determining the exempt status of the fund is to look to the residency status of investors in the fund. This is the approach adopted by Singapore under which an offshore fund may qualify for exemption where more than 80% of the investors in the fund are non-residents. Accordingly, the Singapore test looks to the residency status of the investors in the fund rather than that of the fund itself. | KPMG |
| 2.18 | Supports that the IRD should issue the DIPN to clarify the definition of “central control and management” and to include Annex A of the Administration’s Supplementary Notes (examples of taxable entity and residence under the Bill) in the DIPN so as to provide certainty and clarity as to who does qualify for the exemption under the Bill. | HKAB |

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| 2.19 | <ul style="list-style-type: none"> ● Given that the key objective of the Bill is to provide tax certainty for offshore funds, consistent interpretation and application of the “central management and control” is vital. ● Suggests a clear definition of “central management and control” be provided in the Bill as stated in the Administration’s Supplementary Notes, i.e. the central management and control of a company refers to the highest level of control of the business of the company. | PWC |
| 2.20 | <ul style="list-style-type: none"> ● A clear definition of what constitutes residence must be provided in the Bill and not in a DIPN or Supplementary Notes to the Bill. ● The interpretation that the place of “central management and control” of a company is the place where the highest level of control of the business of the company is exercised must be incorporated in the Bill to provide legal certainty to taxpayers. | HKGCC |
| 3 | <i>Exemption provisions – clause 2: proposed sections 20AC, 20AD</i> | |
| <i>Qualified transactions under the Bill</i> | | |
| 3.1 | <p>The dual “qualified transactions” and “prescribed persons” test (proposed section 20AC(2), (3) and (4)) under the Bill is overly prescriptive and quite narrow in scope. There are three points of concern:</p> <ul style="list-style-type: none"> ● The Bill starts with a limited set of transactions that might qualify for the exemption. But it is silent in relation to many other transactions that an offshore fund might wish to carry out, e.g. dealing in shares in private companies, bills of exchange, promissory notes, certificates of deposit and certain derivative contracts. ● The focus on “qualified transactions” arguably excludes passive income, such as interest, from the scope of the exemption. | CPA |

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| | <ul style="list-style-type: none"> ● As new financial products develop, transactions in these new products might fall outside the scope of exemption. | |
| 3.2 | <p>Suggests extending the definition of “specified transactions” in the Bill to cover transactions such as foreign exchange trading and certain commodity and derivative transactions, as these transactions are commonly engaged by funds in Hong Kong, such as hedge funds.</p> | Ernst & Young |
| 3.3 | <ul style="list-style-type: none"> ● Although the term “securities” is quite widely defined in the SFO, it has excluded common investment instruments invested by offshore fund. Examples are shares in private companies (which most offshore “private equity start-up” funds may typically invest into), and credit derivatives (which offshore hedge funds may transact in). ● Suggests that the definition of “securities” in the Bill should be extended to cover private company shares and other derivative instruments so as to provide a more certain and embracing exemption regime to offshore funds. | Clifford |
| 3.4 | <ul style="list-style-type: none"> ● A number of derivatives and other swap type of products that mainstream investment management firms use on a regular basis appear to be outside the scope of the proposed tax exempt status. ● Urges the Government to consider the above concern either in the wording of the tax law, or in the implementation of the law. | HKSFAL |
| 3.5 | <ul style="list-style-type: none"> ● Welcomes a broader definition of “securities”. Two suggestions for amending the definition, as follows: <ul style="list-style-type: none"> (a) To 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 SFO definition. (b) To add prescribed instruments to the definition, | DTT |

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| | <p>including interest rate derivatives, credit derivatives, OTC commodity derivatives, spot foreign exchange transactions, borrowing/lending money, and physical commodity trading (please see proposed legislative wording in Ref. 2 in Appendix A).</p> <ul style="list-style-type: none"> ● The amended definition should 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 of principally of real property. | |
| 3.6 | <ul style="list-style-type: none"> ● Welcomes the Administration’s proposal of moving CSAs to expand the scope of qualified transactions and the meaning of “securities” in the context of the Bill, and the scope of specified persons. ● The CSAs 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 to the 5% de minimus rule on incidental income. This will greatly help to provide certainty to offshore funds in relation to the exemption. | <p>AIMA PWC</p> <p>PWC</p> |
| 3.7 | <ul style="list-style-type: none"> ● The qualified transactions may not be wide enough to cover all relevant transactions that may be undertaken by offshore funds. For example, borrowing and lending money (including participation as lender in syndicated loans), spot foreign exchange transactions, transactions relating to commodities that can be physically settled and derivatives on derivatives (depending on the terms of the transaction) are not included in the SFO and hence not entitled for exemption. ● Supports the IRD’s proposal to move a CSA to expand the scope of qualified transactions and the meaning of “securities” in the context of the Bill by | HKAB |

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| | adding new schedules. | |
| 3.8 | <ul style="list-style-type: none"> ● The proposed scope of exemption does not cover many transactions typically entered into by CISs. Furthermore, it does not cover a considerable range of transactions of a type which would be allowed if the CISs were regulated by the SFC. Examples are cash deposits, bills of exchanges, and private equities and debentures. ● Strongly recommends that the definition should cover existing transactions commonly entered into by CISs and future developments and products which CISs will enter into. ● Suggests that the definition of “dealings in securities” be expanded to include transactions covered by Type 9 asset management licence under the SFO, namely transactions entered into in providing a service of managing a portfolio of securities or futures contracts for another person. This would add a general definition category, and should Government believe that profits from a particular type of transaction should not be included, then that type of transaction could be specified as an exception to this general category. | HKIFA |
| 3.9 | <ul style="list-style-type: none"> ● The list of qualified transactions as presently drafted is too restrictive. There is concern that the list may exclude many types of transactions that non-resident funds commonly undertake, e.g. shares of private companies in Hong Kong and some derivative transactions entered into in connection with the fund’s business. ● Supports expanding the scope of the exemption to cover all the typical securities-related activities engaged by the funds industry. | KPMG |
| 3.10 | <ul style="list-style-type: none"> ● The qualifying products currently covered in the proposed exemption has not included many transactions traded by funds, such as spot foreign exchange transactions, deposits, certificates of deposit, bills of exchange and promissory notes, | CMTCA |

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| | <p>borrowing and lending money, etc.</p> <ul style="list-style-type: none"> ● Suggests that a list specifying these products be added to the Bill. The Government should reserve the power to amend the list to cater for new products. It would be helpful if the IRD could take note of new products traded by the funds industry in futures years and expand the exemption accordingly instead of going through the legislative process with the LegCo every time that the industry evolves. <p><i>(Remarks: CMTCA has enclosed to its submission the paper prepared by Mr Stephen Fletcher of Linklaters on “Profits Tax exemption for offshore funds - permitted transactions under the SFO”. The paper includes suggested drafting to the proposed sections 20AB and 20AC (para. 5 of that paper) is attached in Appendix B).</i></p> | |
| 3.11 | It would be preferable to include shares in private companies within the scope of exemption. | BCC |
| <i>Qualified transactions carried out through specified persons</i> | | |
| 3.12 | <ul style="list-style-type: none"> ● Considers it appropriate to extend the exemption to transactions “entered into with or through or arranged by someone who is appropriately licensed or registered under other applicable Hong Kong or overseas legislation” rather than just specified or authorized persons under the SFO. ● Seeks clarification as to whether the exemption covers only permitted transactions executed directly by authorized persons or whether the exemption will extend to transactions executed by, for example, third party agents or brokers, upon the instruction of the authorized persons. | KPMG |
| 3.13 | <ul style="list-style-type: none"> ● There may be important occasions where the requirement that an exempt transaction be carried out through an appropriately licensed or registered person under the SFO would not be met. For instance, a fund may trade swaps denominated by Korean equities through a person that is neither licensed nor | CMTCA |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
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| | <p>registered in Hong Kong. It is essential that the proposed exemption give fund managers confidence that their transactions in non-Hong Kong markets will be protected by the proposed legislation.</p> <ul style="list-style-type: none"> ● Suggests that the list of specified persons be expanded, as follows- <ul style="list-style-type: none"> (a) Specified persons should include anyone who is exempt from the need to be licensed. If the Bill is enacted in its current form, offshore funds would be prevented from using many major foreign exchange dealers because the SFO does not require them to be regulated. (b) The Government should require that transactions be carried out by specified persons only if the underlying product is determined by reference to Hong Kong property. For other property, e.g. a swap denominated by a share listed on the Korean stock exchange, it should not be necessary to use a specified person. <p><i>(Remarks: CMTCA has enclosed to its submission the paper prepared by Mr Stephen Fletcher of Linklaters on “Profits Tax exemption for offshore funds - permitted transactions under the SFO”. The paper includes suggested drafting to the proposed sections 20AB and 20AC of (para. 5 of that paper) is attached in Appendix B).</i></p> | |
| 3.14 | <ul style="list-style-type: none"> ● Supports IRD’s proposal to move a CSA to expand the scope of “specified persons” such that a qualified transaction “carried through” any licensed corporation or registered financial institution under the SFO will qualify for the exemption. ● With reference to the term “carried through” in the draft legislation and the IRD’s proposal, for greater legislative clarity, it is recommended that this term be further defined and expanded to “entered into with or through or arranged by [specified persons]”. | HKAB |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
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| <i>Incidental transactions</i> | | |
| 3.15 | <ul style="list-style-type: none"> ● It is not clear what could be regarded as incidental to specified transactions under the Bill (proposed section 20AC(1)(b) and (6)). There is concern that if 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. ● If the suggestion to extend the definition of “specified transactions” is not accepted, suggests that those transactions which are commonly engaged by funds in Hong Kong should be deemed as incidental transactions under the Bill so that the exempt status of the fund would not be tainted. | Ernst & Young |
| 3.16 | <p>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). There are four points of concerns/suggestions, as follows:</p> <ul style="list-style-type: none"> (a) 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. (b) Instead of creating complicated tests to draw a distinction between “incidental transaction” and “other business”, it would be far simpler to remove the distinction and adopt a “de minimus” exemption. For example, a fund’s transactions should be entirely exempt if the non-qualifying transactions do not exceed a prescribed percentage of the qualifying transactions. In contrast, the fund would lose the exemption for a particular year if it were to breach the prescribed percentage threshold. (c) With regard to the percentage threshold that should be applied, the current 5% threshold would be too low for the modified test and would not | DTT |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
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| | <p>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.</p> <p>(d) A reasonable threshold to apply 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 exempted. In contrast, if the thresholds were set too high, it would negate the limitations incorporated into the transactions test (please see the proposed legislative wordings in Ref. 3 in Appendix A).</p> | |
| 3.17 | <ul style="list-style-type: none"> ● It is considered that where a transaction is incidental to the transactions referred to under proposed subsection 20AC(2) to (4), it should be part and parcel of these activities. As such, the incidental transaction should also be exempt transaction with the prescribed activities. ● Accordingly, there is no requirement to set the 5% ceiling (the proposed section 20AC(6)). If a ceiling is set, the definition of “total trading receipts” could be difficult for some trading instruments or transactions. ● Suggests to remove the proposed subsection 20AC(6). | ACCA |
| 3.18 | <ul style="list-style-type: none"> ● Section 20AC(1)(b) and (6) of the Bill disallow a non-resident person from enjoying the tax exemption on profits from incidental transactions if the person’s trading receipts from the incidental transactions exceed 5% of the total trading receipts from the | HKIFA |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
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| | <p>exempt transactions and incidental transactions put together.</p> <ul style="list-style-type: none"> ● Seeks clarification on the following issues: <ul style="list-style-type: none"> (a) With the proposed narrow definition of “dealing in securities”, it is likely that CISs will have considerable “incidental income” and therefore the proposed 5% limit will be easily exceeded. This position will be greatly ameliorated if a wider definition of “dealing in securities” is adopted. (b) Income which is currently not taxable under the IRO should not be included as “incidental income” for the purposes of calculating the 5% limit. It is the intention of the IRD to address this point by way of a practice note stating that items of income which are currently not taxable, e.g. dividends, interest derived on a deposit with an authorized institution in Hong Kong etc, will not be regarded as “incidental income”. | |
| 3.19 | <ul style="list-style-type: none"> ● According to the proposed de minimis test, a non-resident person would lose the exemption in respect of profits from “incidental” non-qualifying transactions that exceed 5% of the total trading receipts from all transactions, although the exemption would continue to apply to other “qualifying” transactions as long as the non-resident person did not engage in any other business in Hong Kong. ● The Bill is drafted such that a non-resident person would appear to lose the entire exemption if he carried on any “other business” in Hong Kong, however small in scale, in comparison to his qualified and incidental transactions. ● More guidance should be provided as to the interpretation of “other business” to clarify its intended application with respect to the ambit and restrictions placed on the operation of the proposed exemption. | KPMG |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
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| 3.20 | <ul style="list-style-type: none"> ● As illustrated in example 10 in Annex A to the Administration’s Supplementary Notes, an overseas holding company carrying on a business other than the prescribed activities in the Bill will not be granted the exemption if it has a Hong Kong branch which carries on this “other business” in Hong Kong. ● However, it is noted that if the operation is carried out by a Hong Kong subsidiary of the overseas company, exemption would be granted. ● Suggests providing an escape clause for the proposed subsection 20AC(5) to the effect that if the prescribed activities are financed by funds of that trade, profession or business in Hong Kong, exemption will be granted. This would encourage inflow of foreign funds. | ACCA |
| 4 | <i>Deeming provisions- clause 2: proposed section 20AE</i> | |
| <i>Application of the deeming provisions</i> | | |
| 4.1 | <ul style="list-style-type: none"> ● Considers that the deeming provisions should not be applicable to resident individuals because, as the law now stands, resident individuals are rarely subject to profits tax on securities transactions unless they are closely connected with the securities industry. Therefore subjecting resident individuals to tax under the deeming provisions in respect of similar income from an investment fund appears unwarranted. ● Two suggestions, as follows: <ul style="list-style-type: none"> (a) The deeming provisions should only apply to resident corporations (which are currently subject to profits tax on securities trading) to prevent these corporations from abusing the exemption provisions. (b) A resident individual who has a direct beneficial interest in an exempt fund should be excluded from the deeming provisions. A resident individual who is associated with the | Ernst & Young |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
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| | <p>exempt fund should remain with the deeming provisions by reason that he/she could be regarded as being closely connected with the securities industry.</p> | |
| 4.2 | <ul style="list-style-type: none"> ● A resident individual who constantly deals in Hong Kong securities could be treated as carrying on a trade in Hong Kong and those trading profits from securities could be subject to profits tax. However, the number of individuals caught by the profits tax regime as a result of trading in Hong Kong securities is extremely low as it is difficult to prove that the dealing activity is carrying out as a trade. ● As an administrative expediency, the Administration should consider carving out individual investors from the deeming provisions as the “tax leakage” resulting from such carve out should be extremely low. | TIHK Clifford |
| 4.3 | <ul style="list-style-type: none"> ● Currently, Hong Kong residents are not subject to profits tax in respect of investment income derived from onshore or offshore funds, provided such persons are not engaged in investment activities as a trade, profession or business. However, under the proposed deeming provisions, Hong Kong residents directly or indirectly holding 30% or more of the beneficial interest in a tax-exempt non-resident entity would be deemed to have derived assessable profits in respect of profits earned by the non-resident fund from qualifying securities trading transactions in Hong Kong. ● Suggests the deeming provisions should only apply to individual resident investors in a fund if their investment in the exempt fund would constitute a business carried on in Hong Kong. This would avoid discrimination against individual investors in a fund as they could be deemed to be taxable on the underlying Hong Kong sourced profits. | KPMG |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
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| 4.4 | <ul style="list-style-type: none"> ● The current draft legislation does not provide an escape clause for dispensing with the application of the deeming provision. ● Suggests that flexibility should be allowed for a resident to escape from the deeming provision if he can justify that no round-tripping is involved. An example is given, as follows: A Hong Kong company has an overseas subsidiary with real business substance and management outside Hong Kong and such subsidiary earns all its income outside Hong Kong. If this subsidiary uses its surplus cash to invest in an exempt offshore fund, the Hong Kong company (which may not be even aware of the investment strategy of the overseas subsidiary) should be provided with an escape clause from the deeming provision. | ACCA |
| 4.5 | <ul style="list-style-type: none"> ● The scope of the deeming provisions is too wide and may discourage managers of genuine funds domiciled overseas coming to Hong Kong. ● Expresses concern that under the deeming provisions, Hong Kong holding companies may be required to pay tax on the profits earned by its overseas subsidiaries/associated corporations from the Hong Kong stock market even though the latter uses their surplus capital to make the investments. The surplus capital was generated from their businesses carried on outside Hong Kong. ● Two suggestions, as follows: <ul style="list-style-type: none"> (a) The deeming provisions should not apply to Hong Kong holding companies where their non-resident subsidiaries/non-resident associated corporations have bona fide active business operations outside Hong Kong and 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. | AIMA |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
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| | (b) Relief from the deeming provisions should be available where the Hong Kong holding companies can prove to the satisfaction of the Commissioner of Inland Revenue that the profits earned by their related companies are in fact genuine overseas monies. | |
| 4.6 | <ul style="list-style-type: none"> ● Supports the deeming provisions but considers that the scope 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. ● Suggests 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. | PWC |
| 4.7 | <ul style="list-style-type: none"> ● Proposed subsection 20AB(2) defines a "resident" person for the purposes of both the exemption provision (proposed section 20AC) and the deeming provision (proposed section 20AE). It should not be the Government's goal to widen the tax net to catch resident individual investors who should not be subject to Profits Tax on their investment income. ● It is suggested that the definition of "resident" for "natural person" should only be included for the interpretation of the exemption provision (i.e. the proposed section 20AC) to avoid the undesirable effect of catching the "natural person" under the deeming provisions. | ACCA |
| 4.8 | <ul style="list-style-type: none"> ● The deeming provision represents a shift from the existing "source-based" taxation system of Hong Kong to one of determining tax liability on the basis | HKGCC |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
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| | <p>of residence. Expresses grave concern that the provision, despite assurances to the contrary, may open Hong Kong to other than territorial tax liability. There are three points of concerns, as follows:</p> <p>(a) The deeming provision is un-justified. The Administration has the anti-avoidance rules in sections 61 and 61A of the IRO to deal with possible abuse of the exemption provision by Hong Kong taxpayers who set up investment funds offshore and conduct otherwise taxable trading through those funds.</p> <p>(b) The sheer scope and potential reach of the deeming provisions will catch many legitimate transactions that would have been desirable from the Government’s perspective in terms of promoting Hong Kong as an investment centre. For example, an overseas subsidiary of a Hong Kong company with excess funds will need to ensure it does not create a tax liability for its parent by taking more than 30% of a fund that is within the exemption provision.</p> <p>(c) The deeming provision will create a new and otherwise unnecessary information gathering burden on Hong Kong based groups who have overseas subsidiaries. Hong Kong corporate groups with operations overseas will be required to implement new information gathering processes to comply with the reporting requirements under the deeming provision. This compliance burden has been discounted by the Administration but will represent a real cost to Hong Kong taxpayers.</p> <ul style="list-style-type: none"> ● Urges the Bills Committee to either reject the deeming provision or amend the Bill to address the concerns. | |
| <i>Triggering threshold – proposed section 20AE(2)</i> | | |
| 4.9 | <ul style="list-style-type: none"> ● It is conceptually difficult to justify the use of a 30% threshold for triggering the deeming provisions. | TIHK Clifford |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
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| | <ul style="list-style-type: none"> ● It will be more equitable to raise the triggering threshold to 50%, given that an investor with a 30% interest in an offshore fund may not have the necessary leverage to request the trustee or the manger of the offshore fund to provide him/her with detailed information required for completing the tax return (especially when the 30% threshold also includes the holdings of associates). ● In respect of offshore funds which have issued various types of shares with different participation and voting rights, investors will need further guidance on how the triggering threshold should be calculated. | |
| 4.10 | <ul style="list-style-type: none"> ● From a tax compliance perspective, resident investor should have at least 50% interest in the exempted offshore fund for it to have a tax reporting obligation and to be assessed. Without at least a 50% interest, it would be difficult for the resident investor to ascertain information for tax reporting purposes and to determine if the relevant gains are capital in nature and/or offshore in nature and thus not assessable. ● Suggests that the Administration should provide further elaborations or guidance on how the triggering threshold should be calculated as offshore funds may have issued different classes of shares. | CPA |
| 4.11 | <ul style="list-style-type: none"> ● While appreciating the rationale of the deeming provisions to identify possible round-tripping transactions carried out by a resident, where the resident investor only holds an insignificant interest in an offshore fund, it may not be appropriate to treat the investor as having control over the activities of the fund, in particular where the interest is held by the resident's overseas associate. ● Suggests to raise the triggering threshold to 50% so that the proposed subsection 20AE(1) will only apply to situation if the resident, on his own or together with associates, has control over the | ACCA |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
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| | non-resident investment. | |
| <i>The term “associate” — proposed section 20AE(3) and (10)</i> | | |
| 4.12 | <ul style="list-style-type: none"> ● The deeming provisions will operate to any Hong Kong resident investor that alone, or together with an associate, holds 30% or more beneficial interest in the fund. However, the deeming provisions apply to any percentage interest in a fund by a Hong Kong resident investor that is associated with the fund. ● The definition of “associate”, used to determine whether a non-resident person will be subject to the deeming provisions, is very broad. There are points of concerns/suggestions: <ul style="list-style-type: none"> (a) A fund manager of a non-resident fund may have special shareholdings, sometimes referred to as “management shares”, which give the fund manager certain additional rights that other investors are not entitled to. (b) Suggests that the associate rules should not apply to the fund manager’s beneficial interest in the fund unless that interest exceeded the 30% threshold that applies to all investors. | KPMG |
| 4.13 | <ul style="list-style-type: none"> ● The deeming provisions currently have 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. As such, it is recommended that an amendment be made to the wording in the proposed section 20AE(3) to resolve this issue (please see the | DTT |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
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| | proposed legislative wordings in Ref. 4.4 in Appendix A). | |
| 4.14 | The term “associate” should be very narrowly and tightly defined in order to help resident investors to comply with the deeming provisions. It will facilitate international groups with a large number of group companies in providing the necessary information to the IRD. | TIHK Clifford |
| 4.15 | The definition of “associate” is too complicated and should be simplified. | CPA |
| <i>Concern about double taxation</i> | | |
| 4.16 | <p>The drafting of the deeming provisions will create tax liabilities on individuals who trade in Hong Kong securities. There are two points of concern:</p> <ul style="list-style-type: none"> ● Individuals who trade in Hong Kong securities would not be subject to profits tax if they have traded in Hong Kong securities in their own names according to the existing IRO. ● If the Bill is enacted, it would impose tax liabilities that currently do not exist. | CPA |
| 4.17 | <ul style="list-style-type: none"> ● Expresses concern that a resident investor could theoretically be double taxed as he/she may be liable to tax in respect of the securities trading income of an exempted offshore under the deeming provisions as well as on his/her eventual disposition of the interest in such exempted fund. ● Suggests that the deeming provisions be amended to remove the possible problem of double taxation mentioned above. | TIHK |
| 4.18 | <ul style="list-style-type: none"> ● As a result of the deeming provisions, the resident person may have to pay tax in place of the offshore fund and may also be liable to tax when he or she sells the shares in the fund. This amounts to double taxation. ● Where a resident investor pays tax on the gain on the | BCC |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
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| | <p>disposal of shares in a listed company, the sale price of the shares would reflect the Profits Tax paid by the company. However, because a resident investor is liable to tax on the undistributed profits of an offshore fund, where that investor disposes of his shares in the fund and realises a gain on the disposal, double taxation would apply (where the gain on the disposal of the units in fund is regarded as Hong Kong-sourced revenue profit), because the price of the shares will not reflect any tax paid.</p> | |
| 4.19 | <ul style="list-style-type: none"> ● Taxpayers could be subject to double taxation under the deeming provisions in certain circumstances, e.g. when 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. ● Two options for addressing the issue, as follows: <ul style="list-style-type: none"> (a) The deeming provisions should be amended so that it should not apply to profits that are taxable in other jurisdictions. If the Government considers 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%) (please see the proposed legislative wordings in Ref. 4.1 in Appendix A); or (b) To eliminate the double taxation by providing a credit for the foreign tax paid. ● Option (a) is preferred because a tax credit mechanism would add an unnecessary level of complexity to the already complicated rules. | <p>DTT CPA</p> <p>DTT</p> |
| 4.20 | <ul style="list-style-type: none"> ● The provisions as currently drafted deem assessable profits arising on a resident holding a requisite level of beneficial interest in a tax-exempt non-resident, irrespective of whether actual distributions were made by the non-resident to the resident. | KPMG |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
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| | <ul style="list-style-type: none"> ● Under the Bill, a resident would be subject to tax on unrealized profits that they have not yet derived or in fact, may never derive. For example, the profits may never be derived by the resident if the resident disposed of his interest in the non-resident prior to receiving a distribution. ● The proposed provisions may therefore give rise to double taxation where a resident may be assessed on the deemed profits and again upon a revenue gain on disposal of its investment in the non-resident. ● Two options for addressing the issue, as follows: <ul style="list-style-type: none"> (a) The resident investors should be taxed on their share in the profits of the tax-exempt entity at the point of actual distribution only. Upon receiving a distribution, the profits derived would be dissected between taxable and non-taxable components in the hands of the resident investor; or (b) To introduce a provision that allows the resident investors a tax offset for the tax paid on the deemed gain if the same gain was taxed again on disposal. | |
| 4.21 | <ul style="list-style-type: none"> ● The Administration has not adequately considered and addressed the business communities' concerns in relation to the double taxation of income that could arise as a direct result of the operation of the deeming provisions. ● The Administration might have overlooked the difference between (i) taxes paid by two different persons (e.g., a shareholder and a corporation) on different forms of income (Paragraph 25 of the Administration's Supplementary Notes), and (ii) taxes paid by the same person twice (Paragraph 26 of the Administration's Supplementary Notes). ● The double taxation could be aggravated in situations | HKGCC |

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| | <p>where the non resident person is also subject to tax imposed by another country. This is inequitable and can only lend to Hong Kong based groups simply issuing blanket instructions that overseas subsidiaries are to make no investments in funds that invest in Hong Kong. Such a result is hardly supportive of the Government's initiative of promoting Hong Kong's investment fund industry.</p> | |
| <i>Other concerns on the deeming provisions</i> | | |
| 4.22 | <ul style="list-style-type: none"> ● The deeming provisions attribute exempt profits to certain resident investors but not losses. This inconsistent treatment can lead to inequitable results, i.e. the investor would be subject to tax on an investment that economically generated a loss. ● Recommends that amendments be made to the deeming provisions so that both profits and losses could be attributed to the resident investor and allow the investor to set off and carry forward any such losses. | CPA |
| 4.23 | <ul style="list-style-type: none"> ● If the deeming provisions are triggered, the Hong Kong resident investor will be attributed an amount of profit proportionate to the non-resident person's exempt income, the resident investor's interest in the non-resident person and the period of ownership. However, the proposed provisions are silent on whether the attribution rules will operate if the non-resident person makes a loss from its qualified activities carried out in Hong Kong. ● The Administration should clarify this point as it would seem inequitable if the resident investor is only attributed the profits but not losses made by the non-resident person. | KPMG |
| 4.24 | <ul style="list-style-type: none"> ● If an offshore fund is not exempted, it should be treated in the same way as any other Hong Kong company and, thus, there would be no reason to deny it loss relief. ● As regards the application of general anti-avoidance | BCC |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
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| | provisions under section 61A of the IRO, in the normal course of events, any artificial transactions are ignored and, if the taxpayer then becomes taxable, he or she is entitled to offset any losses that may arise. | |
| 4.25 | Supports the Administration's proposal to move a CSA to carve out management shares from the application of the deeming provisions (see paragraph 23 of the Administration's Supplementary Notes). | AIMA PWC |
| 5 | <i>Retrospective application of the Bill (proposed section 20AC(1))</i> | |
| 5.1 | It is encouraging to find that the Bill will have retrospective effect from 1 April 1996. | AIMA |
| 5.2 | Strongly supports the retrospective application of the exemption provisions. | PWC |
| 5.3 | <p>Strongly supports the retrospective application of the exemption provision. There is a real need for such a provision for the following reasons:</p> <ul style="list-style-type: none"> ● The IRD has had an unofficial policy of not taxing foreign funds using Hong Kong investment managers. The above practice was publicly stated by the IRD at paragraph 5 of its Practice Note No. 30: Profits Tax: Section 20AA - Persons not Treated as Agents. Hong Kong has a reputation for certain and simple tax law. Hong Kong's reputation would be damaged if the Practice Note is ignored and CISs are taxed in relation to the past six years. ● Failure to apply the exemption to the past six years would be inequitable and could have serious negative consequences, as follows - <ul style="list-style-type: none"> (a) It would result in tax being applied to foreign investors in relation to only those past six years, as before that period (which is now time barred) investors would have benefited from the IRD's practice, and after the six-year period investors would be covered by the new exemption. | HKIFA |

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| | <p>(b) This would go against the IRD's Practice Note No. 30, on which investors and the Hong Kong asset management industry have relied upon and which was issued to the public before the start of the six-year period.</p> <p>(c) Significant investments are made into Hong Kong by CISs, into which investors frequently come and go. If they are to receive an assessment now in relation to past years, this will severely disadvantage those current investors who were not invested in the years the gains were made and are now having to bear the tax burden in relation to those past gains which they did not benefit from.</p> <p>(d) CISs would face very difficult valuation issues as their auditors would have to consider potential liabilities for back years.</p> | |
| 5.4 | <ul style="list-style-type: none"> ● Expresses concern that the IRD may issue back Profits Tax Assessments on funds which did not comply with the new laws, and where the IRD has detailed information on hand about those funds but have not so far raised assessments whilst this legislation is being discussed. Such funds, which will mostly be boutique funds have not accrued for such Profits Tax charges in their accounts. ● As such, there should be no retrospective action on the Bill. If enacted, the Bill should be implemented with effect from 1st April 2006, not 1st April 1996 as currently proposed. | BCC |
| 6 | <i>Schedule 15 – provisions for ascertaining amount of assessable profits of resident person under section 20AE</i> | |
| 6.1 | <ul style="list-style-type: none"> ● The formula provided under Schedule 15 assumes that profits are derived evenly on a daily basis over the accounting year and ignores the commercial reality that the performance and value of an offshore fund does fluctuate and that investors will enter or | ACCA |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
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| | <p>exit a fund making gain or loss at any time during the year.</p> <ul style="list-style-type: none"> ● Taking into account the profits of the non-resident person for the accounting period instead of the holding period of the resident person could be extremely disadvantageous to the resident. As an illustration, if a resident derives a loss by holding an investment for only a very short period of time, and the period falls within an accounting year of the non-resident which reports an overall profit, the resident will have deemed assessable profits despite that he derived an actual holding loss. ● Two suggestions, as follows: <ul style="list-style-type: none"> (a) The amount of assessable profits should be ascertained by the amount derived from the prescribed formula or the actual gain of the resident, whichever is lower. (b) Where the resident derives a loss from the holding of the investment, no assessable profits should be calculated accordingly. | |
| 6.2 | <ul style="list-style-type: none"> ● The formula in the proposed Schedule 15 imposes unreasonable onerous obligations in terms of keeping information on units held in funds. ● The investment managers are required to keep a record of the number of units held in a fund on each day in the period. But most unregulated funds provide for monthly or quarterly dealings and so only prepare monthly or quarterly as opposed to daily valuations. ● Suggests that the formula should be based on the average number of shares in issue over the year. | AIMA PWC |
| 6.3 | <ul style="list-style-type: none"> ● It is difficult to determine the source and capital/revenue nature of transactions of the non-resident person during a given year of assessment. It is also unclear in the Bill who has the obligation to make such a determination. | KPMG |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
|-----|---|--|
| | <p>There are two points of concerns, as follows:</p> <p>(a) A record of the beneficial interests held by Hong Kong resident investors in the non-resident must be kept for each day in a year of assessment. This is a very onerous administrative obligation for the Hong Kong resident investors.</p> <p>(b) Technically speaking, it is the taxpayer's responsibility to submit a correct tax return. However, a resident investor in a fund would need to rely on information provided by the non-resident fund in completing its Hong Kong tax filing. There will be significant compliance obligations for the non-resident fund given the legal/tax analysis involved in making the source and capital/revenue nature determinations.</p> <ul style="list-style-type: none"> ● Recommends that provisions be introduced to the effect that the Hong Kong resident investors cannot be penalized for relying on information provided by the fund manager, if the information is subsequently found to be incorrect. This will alleviate the potential cumbersome burden imposed on the resident investors. | |
| 6.4 | <ul style="list-style-type: none"> ● 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 provisions 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. ● It is recommended that an additional section be | DTT |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
|-----|--|--|
| | inserted into the proposed Schedule 15 to overcome the matter (please see the proposed legislative wordings in Ref. 4.3 in Appendix A). | |
| 7 | <i>Other comments</i> | |
| 7.1 | <p>The Bill has not dealt with the following important issues:</p> <ul style="list-style-type: none"> ● Tax avoidance - The Bill imposes a particular tax avoidance test on a specific class of business. But it does not exclude the tax avoidance test. The Administration should clarify whether the Bill includes or excludes the general test of tax avoidance as provided in section 61A of the IRO. ● Source of profit - The Bill specifies a particular profit source specific to a specific class of business. But it does not specify whether Rule 5 of the Inland Revenue Rules (Cap 112A) (which specifies a general test of profits tax liability for non-resident persons deriving a Hong Kong-source profit) is to be included or excluded from the Bill's tests of source of profit. The Administration should clarify this point. | Gunson |
| 7.2 | <ul style="list-style-type: none"> ● Considers the profits generated on investments made by venture capital and private equity funds typically to be capital in nature which should fall outside the scope of Hong Kong Profits Tax irrespective of where such funds source their capital. ● Seeks more formal clarification of the non taxation of such profits and, thus, the non-application of the Bill to venture capital and private equity funds notwithstanding that they may be serviced by venture capital or private equity fund managers or advisers operating in Hong Kong. ● Reiterates 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. | <p>HKVCA</p> <p>PWC</p> |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
|-----|---|--|
| 7.3 | <ul style="list-style-type: none"> ● The Bill excludes from its scope securities issued by private companies which are the focus of investments made by venture capital and private equity funds. Hence, while the Bill will be a helpful piece of legislation for funds investing in securities issued by publicly-listed companies, it is of limited relevance to funds, particularly venture capital and private equity funds, which focus on investing in securities issued by private companies. ● The Bill does not address the taxation status of funds that make investments in both securities issued by publicly-listed companies which are included in the Bill and those by private companies which are not. | HKVCA |
| 7.4 | <ul style="list-style-type: none"> ● The Bill only refers to “securities” as defined in the SFO, which specifically excludes private companies as defined under the Companies Ordinance. This will exclude from the proposed exemption an important sector of the funds industry in Hong Kong, namely private equity funds. Such investments should not be excluded. ● Genuine offshore private equity funds that may be managed by a Hong Kong based fund manager should not be excluded from the ambit of the proposed exemption. The private equity represents an important component of the funds industry in Hong Kong and the absence of an exemption in Hong Kong for such funds could lead to them relocating to other jurisdictions in the region. | KPMG |
| 7.5 | <ul style="list-style-type: none"> ● Suggests to provide a broad based exemption for offshore funds by expanding the exemption for bona fide widely held funds currently contained in Section 26A(1A) of the IRO. For example, the exemption should be expanded to cover all offshore CISs as defined in the SFO. ● The above suggestion would cover many funds that might want to invest in Hong Kong but which do not currently satisfy the bona fide widely held test. | CPA |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
|-----|---|--|
| 7.6 | Considers it important to extend taxation relief to non SFC-authorized funds that are not currently exempted from profits tax as they play a vital role in Hong Kong’s asset management industry. | Ernst & Young |
| 7.7 | <ul style="list-style-type: none"> ● 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. | PWC |
| 7.8 | <ul style="list-style-type: none"> ● When funds are first founded, they are often capitalized 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 organizers 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. This would have a detrimental effect on attracting new funds to invest in Hong Kong. ● In order to remove the deterrent effect, it is suggested that the deeming provision should not apply to funds in their first two years of operations (please see proposed legislative wordings in Ref 4.2 in Appendix A). | DTT |
| 7.9 | <ul style="list-style-type: none"> ● Under the current tax legislation, offshore funds listed on the Hong Kong Stock Exchange are not tax-exempt as the Hong Kong Stock Exchange is not listed as a supervisory authority within an acceptable regulatory regime under section 26A(1A)(ii) of the IRO (which specifically exempts offshore funds from being taxed in Hong Kong, if the offshore funds are bona fide widely held). | AIMA |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
|------|--|--|
| | <ul style="list-style-type: none"> ● The exemption provisions of the Bill proposes to exempt offshore funds from tax only if these funds are not carrying on other business in Hong Kong (the proposed section 20AC(5)). It is understood that overseas investment companies listed in Hong Kong need to register as overseas companies at the Hong Kong Companies Registry. If this registration will constitute carrying on business in Hong Kong by such funds, the proposed tax exemption will not be applicable to them. ● The Administration should encourage more overseas funds to be listed in Hong Kong. Suggests to amend the exemption provisions to exempt offshore funds listed in Hong Kong. | |
| 7.10 | <ul style="list-style-type: none"> ● 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). ● Expresses concern about 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. ● Suggests that the exemption provisions should be extended to cover offshore funds listed in Hong Kong. | PWC |
| 7.11 | Suggests that the Bills Committee should make reference to the New Zealand IRD's publication "Taxation of Investment Income" (which deals with issues on structural problem of taxation of collective investment schemes) and the updated Double Taxation Agreement model announced by the Organization for Economic Cooperation and Development (which partly deals with the issue of multiple permanent establishments). | Gunson |

| | Views of organizations/individuals on major issues of the Bill | Name of organization/individual |
|------|---|--|
| 7.12 | The proposed amendments, clarifications and proposals noted by the IRD in the Administration's Supplementary Notes should be either incorporated in the Bill or in a DIPN as appropriate. | HKAB CMTCA |

Council Business Division 1
Legislative Council Secretariat
21 October 2005

**Submission from DTT
(LC Paper No. CB(1)44/05-06(08))**

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. |
|--|------|
| <p><i>[Amend subsection 20AB(2)]</i></p> <p>20AB(2) In relation to any year of assessment, a person is to be regarded as a resident person if-</p> <p>...</p> <p>(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;</p> <p>(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;</p> <p>(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.</p> | 1 |
| <p><i>[Amend subsection 20AC(1)]</i></p> <p>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-</p> <p>(a) transactions falling within subsection (2), (3) or (4) that are carried out in that year of assessment; and</p> <p>(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) that are incidental to the carrying out of the transactions referred to in paragraph (a).</u></p> | 3 |
| <p><i>[Insert new subsection 20AC(2)(c)]</i></p> <p>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:</p> <ul style="list-style-type: none"> (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 <p><i>[Further definitions may be required for items (i) to (vi)]</i></p> | 2 |

| Draft legislative amendments | Ref. |
|--|-------------|
| <p><i>[Replace section 20AC(5) with the following]</i></p> <p>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).</p> | 3 |
| <p><i>[Delete section 20AC(6)]</i></p> | 3 |
| <p><i>[Amend subsection 20AE(3)]</i></p> <p>... 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 <u>resident person is an associate of the non-resident person...</u></p> | 4.2 |
| <p><i>[Insert new subsection 20AE(9)]</i></p> <p>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.</p> | 4.2 |
| <p><i>[Re-number existing subsection 20AE(9) to new subsection 20AE(10)]</i></p> | 4.2 |
| <p><i>[Insert new subsection 20AE(11)]</i></p> <p>Where</p> <p>(a) the non-resident person derives assessable profits that would have been chargeable to tax under this Part but for section 20AC; and</p> <p>(b) the non-resident person is liable to income tax in a foreign jurisdiction in respect of an amount of those assessable profits;</p> <p>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.</p> | 4.1 |
| <p><i>[Re-number existing subsection 20AE(10) to new subsection 20AE(12)]</i></p> | 4.18 4.2 |
| <p><i>[Re-number existing subsection 20AE(11) to new subsection 20AE(13)]</i></p> | 4.18 4.2 |
| <p><i>[Insert new section 4 in Part 2 to Schedule 15]</i></p> <p>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."</p> | 4.3 |

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年利達律師事務所

Memorandum

14 October 2005

To David Sutherland, Capital Markets Tax Committee of Asia Hong Kong Chapter

From Stephen Fletcher

Direct Line 00 852 2901 5350

Profits Tax Exemption for Offshore Funds - Permitted transactions under Securities and Futures Ordinance

1 Executive Summary

The Government has proposed exempting revenue earned by certain offshore persons from Hong Kong profits tax. The Government's proposals are currently set out in the Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005. Under the Bill, the exemption is limited primarily to transactions which (a) amount to "dealing in securities", "dealing in futures contracts" or "leveraged foreign exchange trading" under the Securities and Futures Ordinance ("SFO") and (b) are carried out through persons licensed/registered under the SFO for those activities (or, in some cases, for the activity of "asset management").

This memorandum explains why many transactions commonly entered into by offshore funds would fall outside the exemption as drafted – because the definitions of "dealing in securities", etc. under the SFO are relatively limited (see 2 and 3 below), and because often transactions are not entered into through persons who are licensed/registered under the SFO for the relevant activities (see 2 and 4 below). While many transactions typically executed by hedge funds are within the SFO, many transactions are not, including, in particular, many interest rate derivatives, credit derivatives, OTC commodity derivatives, deposits, spot foreign exchange transactions, borrowing/lending money, insurance contracts and physical commodity trading.

We understand that the Government does not intend the exemption to be unduly narrow, and is prepared to introduce amendments to the Bill to extend the exemption appropriately. Accordingly, we have suggested some amendments to help to achieve this.

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2 SFO definitions

This section explains what transactions are caught by the definitions of "dealing in securities", "dealing in futures contracts" and "leveraged foreign exchange trading" under the SFO.

2.1 Dealing in securities

2.1.1 Introduction

The definition of "dealing in securities" under the SFO is essentially limited to two types of transaction: (1) buying/selling "securities"; and (2) entering into certain derivatives over "securities". "Securities" is quite broadly defined to include shares, bonds, notes, units in funds, warrants and various physically-settled derivatives over shares, bonds, etc.

However, it obviously does not cover transactions which do not involve "securities", e.g. interest-rate derivatives, commodity derivatives, foreign exchange derivatives, many 'credit default' derivatives, etc.

Please see 3 below.

2.1.2 Definition

"Dealing in securities" is defined under Schedule 5 to the SFO to mean: making (or offering to make) an agreement with another person, or inducing (or attempting to induce) another person to enter into (or to offer to enter into) an agreement:

- (a) for or with a view to acquiring, disposing of, subscribing for or underwriting "securities"; OR
- (b) the purpose or pretended purpose of which is to secure a profit to any of the parties from the yield of "securities" or by reference to fluctuations in the value of "securities".

It is important to note the difference between limbs (a) and (b) above: limb (a) is about buying and selling products that are themselves "securities"; limb (b) is about entering into derivatives which are designed to generate a profit from the income earned on "securities" or from fluctuations in the value of "securities" (i.e., it is not necessary that the derivative in (b) is itself a "security" as defined in the SFO).

"Securities" is defined under Schedule 1 to the SFO to include:

- (a) shares, stocks, debentures, funds, bonds or notes whether issued by a Hong Kong or offshore company, unincorporated body or any governmental authority;
- (b) rights, options or interests in or in respect of any of the instruments in (a);
- (c) certificates of interest in, receipts for or warrants to subscribe for or purchase any of the instruments in (a);
- (d) interests in any "collective investment scheme" (which is itself broadly defined under the SFO to include a broad range of funds); and

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- (e) any interests commonly known as securities.

A number of instruments are expressly excluded from the above list. These include: shares and debentures of Hong Kong private companies; interests in collective investment schemes that are registered pension schemes under the Mandatory Provident Fund Schemes Ordinance or Occupational Retirement Schemes Ordinance, or that are also insurance contracts under the Insurance Companies Ordinance; non-investment partnerships; negotiable certificates of deposit; bills of exchange and promissory notes under the Bills of Exchange Ordinance; and non-negotiable/transferable debentures.

The Financial Secretary is also empowered under the SFO to specify that an interest, etc. is or is not a "security" within the above.

We would make several observations about this list:

- There is no requirement that the "securities" be listed or admitted to trading on any stock exchange anywhere
- In relation to (b) above, we have in the past been advised by leading counsel that this only includes physically-settled derivatives over the instruments in (a), e.g. an option contract over shares which allows the holder to call for physical delivery of those shares.
- (e) above is somewhat unhelpful, since in practice it is not at all obvious what other instruments other than those listed in (a) to (d) would commonly be regarded as "securities".
- the exemptions from the list should not be forgotten – in particular the exemptions for insurance contracts, negotiable certificates of deposit and non-negotiable/transferable debentures.

The application of the above to offshore funds' activities in Hong Kong is set out in 3 below.

2.1.3 Exemptions

The SFO sets out a number of exemptions from "dealing in securities". It is important to note that the exemptions work by providing that the specified activity does not fall within the definition of what constitutes "dealing in securities". Three are particularly important in this context:

- a person ("A") is not regarded as "dealing in securities" where the relevant act is performed through another person ("B") who is licensed or registered for "dealing in securities" under the SFO. However, A will not be able to rely on this exemption where, in return for some commission, rebate or other remuneration, A 'deals' with B for the account of a third party or introduces potential clients to B or deals with third parties on behalf of B.
- a person is not regarded as "dealing in securities" where he performs the relevant act as principal and by way of dealing with certain categories of "professional investor" (as defined under the SFO),

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including persons licensed or registered under the SFO, Hong Kong banks, etc.

- a person is not regarded as "dealing in securities" where he acquires, disposes of or subscribes for securities as principal.

The effect of these exemptions is that a person who can benefit from them is not "dealing in securities". See 3 and 4 below.

2.2 Dealing in futures contracts

2.2.1 Introduction

The definition of "dealing in futures contracts" under the SFO is essentially limited to: buying/selling "futures contracts", i.e., exchange-traded futures and options on such futures.

The definition does not cover non-exchange traded products, i.e., all off-exchange derivatives.

Please see 3 below.

2.2.2 Definition

"Dealing in futures contracts" is defined under Schedule 5 to the SFO to mean:

- (a) making (or offering to make) an agreement with another person to enter into (or to acquire or dispose of) a "futures contract";
- (b) inducing (or attempting to induce) another person to enter into (or to offer to enter into) a "futures contract";
- (c) inducing (or attempting to induce) another person to acquire or dispose of a "futures contract".

"Futures contract" is defined under Schedule 1 to the SFO to mean a contract (or option on a contract) made under the rules or conventions of a "futures market".

A "futures market" is, in turn, defined as a place at which facilities are provided for persons to negotiate or conclude sales or purchases of contracts (or options on contracts) the effect of which is that:

- one party agrees to deliver to the other at an agreed future time an agreed (quantity of) property at an agreed price; or
- the parties will make an adjustment between themselves at an agreed future time according to whether an agreed property is worth more or less or an index or other factor stands higher or lower than a value or level agreed at the time of making the contract;

provided that, in both cases, either the contracts (or options) are novated or guaranteed by a central counterparty under the rules or conventions of the market in question, or the contractual obligations of the parties are normally discharged before the contractual expiry date under the rules or conventions of the market in question.

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The application of the above to offshore funds' activities in Hong Kong is set out in 3 below.

2.2.3 Exemptions

The SFO sets out a number of exemptions from "dealing in futures contracts". Again, the exemptions work by providing that the specified activity does not fall within the definition of what constitutes "dealing in futures contract". Two are particularly important in this context:

- a person ("A") is not regarded as "dealing in futures contracts" where the relevant act is performed through another person ("B") who is licensed or registered for "dealing in futures contracts" under the SFO. However, A will not be able to rely on this exemption where, in return for some commission, rebate or other remuneration, A 'deals' with B for the account of a third party or introduces potential clients to B or deals with third parties on behalf of B.
- a person is not regarded as "dealing in futures contracts" where he performs the relevant act as principal in relation to futures contracts traded on any exchange other than the Hong Kong Futures Exchange and by way of dealing with certain categories of "professional investor" (as defined under the SFO), including persons licensed or registered under the SFO, Hong Kong banks, etc.

The effect of these exemptions is that a person who can benefit from them is not "dealing in futures contracts". See 3 and 4 below.

2.3 Leveraged foreign exchange trading

2.3.1 Introduction

The definition of "leveraged foreign exchange trading" under the SFO includes three activities: (1) buying/selling "leveraged foreign exchange contracts"; (2) providing margin facilities to enable another person to engage in spot or leveraged foreign exchange trading; and (3) entering into arrangements to facilitate leveraged foreign exchange trading.

Only the first of these is particularly relevant in the current context.

The definition does not cover 'spot' foreign exchange transactions.

Please see 3 below.

2.3.2 Definition

"Leveraged foreign exchange trading" is defined under Schedule 5 to the SFO to mean:

- (a) the act of entering into or offering to enter into (or inducing or attempting to induce a person to enter into or to offer to enter into) a "leveraged foreign exchange contract";
- (b) the act of providing any financial accommodation to facilitate "foreign exchange trading" or to facilitate an act referred to in (a) above; or

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- (c) the act of entering into or offering to enter into (or inducing or attempting to induce a person to enter into) an arrangement with another person, on a discretionary basis or otherwise, to enter into a contract to facilitate an act referred to in paragraph (a) or (b) above.

“Leveraged foreign exchange contract” is defined under Schedule 5 to the SFO to mean contracts or arrangements the effect of which is that one party agrees to:

- (a) make an adjustment between himself and the other party or another person according to whether a currency is worth more or less (as the case may be) in relation to another currency;
- (b) pay an amount of money or to deliver a quantity of any commodity determined or to be determined by reference to the change in value of a currency in relation to another currency; or
- (c) deliver to the other party or another person at an agreed future time an agreed amount of currency at an agreed consideration.

“Foreign exchange trading” is also defined in Schedule 5 to mean entering into or offering to enter into (or inducing or attempting to induce a person to enter into or to offer to enter into) a contract or arrangement whereby any person undertakes to exchange currency with another person, deliver an amount of foreign currency to another person, or credit the account of another person with an amount of foreign currency.

The application of the above to offshore funds’ activities in Hong Kong is set out in 3 below.

2.3.3 Exemptions

Again, the SFO provides for various exemptions which work by providing that the specified activity does not fall within the definition of what constitutes “leveraged foreign exchange trading”. Several are particularly important in this context:

- where the contract or arrangement is entered into by a company (i) whose principal business is not dealing in currencies, (ii) for the purpose of hedging its exposure to currency exchange risks in connection with its business, and (iii) with another company;
- where the contract or arrangement is arranged by a Hong Kong authorised ‘money broker’ and every party to which is a company or a Hong Kong partnership;
- where the exemptions set out in the Securities and Futures (Leveraged Foreign Exchange Trading – Exemption) Rules apply, i.e., where a person’s principal business is not in leveraged foreign exchange spot transactions, or the average principal amount of each leveraged foreign exchange spot transaction (calculated in accordance with the Rules for the person’s financial year) is not less than HK\$7.8 million, and the person either

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- (a) has a credit rating (or any of its debt instruments has a credit rating) of (i) Moody's – A3 or above for long term debt or Prime-3 or above for short term debt; or (ii) Standard & Poor's – A or above for long term debt or A-3 or above for short term debt; or
- (b) is a wholly owned subsidiary of another company which has such a credit rating (or any of whose debt instruments has such a rating).

Once again, the effect of these exemptions is that a person who can benefit from them is not engaged in "leveraged foreign exchange trading". See 3 and 4 below.

3 Application to products commonly traded by offshore funds

3.1 Table of products

The table below sets out common activities and products traded by offshore funds with and through Hong Kong brokers, fund managers and counterparties, and notes whether the above SFO definitions apply to those activities and transactions.

| Product/Transaction | Caught under above SFO definitions? |
|--|--|
| 1 Foreign exchange/currencies | |
| Foreign exchange forwards | Yes (leveraged foreign exchange trading) |
| Foreign exchange options | |
| Currency swaps | |
| Spot foreign exchange transactions | No |
| Deposits | No |
| Buying/selling certificates of deposit, bills of exchange and promissory notes | No |
| Borrowing/lending money (in any currency, and whether on a secured or unsecured basis) (including participating as a lender in syndicated loans, selling sub-participations in loans to third parties, etc.) | No |
| 2 Equities | |
| Buying/selling listed equities (whether in Hong Kong or elsewhere) | Yes (dealing in securities – limb (a)) |
| Buying/selling unlisted equities issued by 'public' companies (whether incorporated in Hong Kong or elsewhere) | Yes (dealing in securities – limb (a)) |
| Buying/selling Hong Kong private equities | No (these equities are not "securities") |

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| Product/Transaction | Caught under above SFO definitions? |
|---|--|
| Buying/selling offshore private equities | Yes (dealing in securities – limb (a)) |
| Stock borrowing and lending and repurchase and reverse-repurchase transactions in equities | Yes (dealing in securities – limb (a)) (assuming that the equities being borrowed/loaned are not those of a Hong Kong private company) |
| Hedging activities involving buying and selling equities as a hedge to some derivative or other position | Yes (dealing in securities – limb (a)) (assuming that the equities in question are not those of a Hong Kong private company) |
| Short selling equities (whether on market or off market) | Yes (dealing in securities – limb (a)) (assuming that the equities in question are not those of a Hong Kong private company) |
| 3 Equity derivatives | |
| Buying/selling exchange-traded futures contracts over equities (including equity index products) | Yes (dealing in futures contracts) |
| Buying/selling exchange-traded options on futures contracts over equities (including equity index products) | Yes (dealing in futures contracts) |
| Buying/selling exchange-traded stock option contracts over equities (including equity index products) | Yes (dealing in securities – limb (a)) |
| Entering into OTC equity contracts for differences (whether over one or more equities) | Yes (dealing in securities – limb (b)) |
| Entering into OTC call/put options over equities (physical delivery) (whether over one or more equities) | Yes (dealing in securities – limb (a)) |
| Entering into OTC call/put options over equities (cash settlement) (whether over one or more equities) | Yes (dealing in securities – limb (b)) |
| Entering into OTC forwards over equities (physical delivery) (whether over one or more equities) | Yes (dealing in securities – limb (a)) |
| Entering into OTC forwards over equities (cash settlement) (whether over one or more equities) | Yes (dealing in securities – limb (b)) |
| Entering into OTC equity asset swaps, total return swaps, swaptions (whether over one or more equities) | Yes (dealing in securities – often a combination of limb (a) and limb (b) depending on the terms of the particular transaction) |

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| Product/Transaction | Caught under above SFO definitions? |
|--|--|
| Buying/selling warrants (whether exchange traded or OTC) | Yes (dealing in securities – limb (a)) |
| Entering into OTC swaps of dividend on equities against some other income stream (whether over one or more equities) | Yes (dealing in securities – limb (b)) |
| 4 Funds | |
| Buying/selling funds (whether exchange traded or not) | Yes (dealing in securities – limb (a)) |
| Buying/selling funds of funds | Yes (dealing in securities – limb (a)) |
| Buying/selling hedge funds | Yes (dealing in securities – limb (a)) |
| Entering into OTC call/put options over funds (physical delivery) (whether over one or more funds) | Yes (dealing in securities – limb (a)) |
| Entering into OTC call/put options over funds (cash settlement) (whether over one or more funds) | Yes (dealing in securities – limb (b)) |
| Entering into OTC forwards over funds (physical delivery) (whether over one or more funds) | Yes (dealing in securities – limb (a)) |
| Entering into OTC forwards over funds (cash settlement) (whether over one or more funds) | Yes (dealing in securities – limb (b)) |

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| 5 Fixed income | |
|---|--|
| Buying/selling any listed bonds, debentures or notes (whether in Hong Kong or elsewhere) (including 'plain vanilla' bonds, bonds with warrants, convertible bonds, exchangeable bonds, structured notes, asset-backed securities, mortgage-backed securities) | Yes (dealing in securities – limb (a)) |
| Buying/selling any unlisted bonds, debentures or notes issued by 'public' companies (whether incorporated in Hong Kong or elsewhere) (including 'plain vanilla' bonds, bonds with warrants, convertible bonds, exchangeable bonds, structured notes) | Yes (dealing in securities – limb (a)) |
| Buying/selling any unlisted bonds, debentures or notes issued by Hong Kong private companies (including 'plain vanilla' bonds, bonds with warrants, convertible bonds, exchangeable bonds, structured notes) | No (if these instruments are "debentures", they are not "securities") |
| Buying/selling any unlisted bonds, debentures or notes issued by offshore private companies (including 'plain vanilla' bonds, bonds with warrants, convertible bonds, exchangeable bonds, structured notes) | Yes (dealing in securities – limb (a)) |
| Stock borrowing and lending and repurchase Stock borrowing and lending and repurchase and reverse-repurchase transactions in any bonds, debentures or notes | Yes (dealing in securities – limb (a)) (assuming that any debentures being borrowed/loaned are not those of a Hong Kong private company) |
| Hedging activities involving buying and selling any bonds, debentures or notes as a hedge to some derivative or other position | Yes (dealing in securities – limb (a)) (assuming that any debentures in question are not those of a Hong Kong private company) |
| Short selling any bonds, debentures or notes (whether on market or off market) | Yes (dealing in securities – limb (a)) (assuming that any debentures in question are not those of a Hong Kong private company) |
| 6 Fixed income derivatives | |
| Entering into OTC call/put options over bonds, debentures or notes (physical delivery) (whether over one or more bonds, debentures or notes) | Yes (dealing in securities – limb (a)) |
| Entering into OTC call/put options over bonds, debentures or notes (cash settlement) (whether over one or more bonds, debentures | Yes (dealing in securities – limb (b)) |

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| | |
|---|---|
| or notes) | |
| Entering into OTC forwards over bonds, debentures or notes (physical delivery) (whether over one or more bonds, debentures or notes) | Yes (dealing in securities – limb (a)) |
| Entering into OTC forwards over bonds, debentures or notes (cash settlement) (whether over one or more bonds, debentures or notes) | Yes (dealing in securities – limb (b)) |
| Entering into OTC bond, debenture or note asset swaps, total return swaps, swaptions (whether over one or more bonds, debentures or notes) | Yes (dealing in securities – often a combination of limb (a) and limb (b) depending on the terms of the particular transaction) |
| Entering into OTC swaps of interest paid on bonds, debentures or notes against some other income stream (whether over one or more bonds, debentures or notes) | Yes (dealing in securities – limb (b)) |
| Entering into OTC credit default swaps (cash settled) | No |
| Entering into OTC credit default swaps (physical delivery of the underlying reference obligations) | No (unless reference obligations themselves are or include bonds, debentures or notes, in which case, yes – dealing in securities – limb (a)) |
| Buying/selling credit-linked notes (whether listed or unlisted) | Yes (dealing in securities – limb (a)) |
| Buying/selling collateralised debt obligations | Yes (dealing in securities – limb (a)) |
| 7 Interest rate derivatives | |
| Entering into OTC interest rate swaps (whether fixed rate v fixed rate, fixed rate v floating rate, or floating rate v floating rate) | No (unless also some currency element to the swap in which case it might be leveraged foreign exchange trading) |
| Entering into OTC interest rate options, swaptions, caps, collars, floors, etc. | No (unless also some currency element to the swap in which case it might be leveraged foreign exchange trading) |
| 8 Commodities | |
| Buying/selling commodities (physical delivery) | No |
| Buying/selling exchange-traded futures contracts over commodities (including commodity index products) | Yes (dealing in futures contracts) |

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| | |
|---|---|
| Buying/selling exchange-traded options on futures contracts over commodities (including commodity index products) | Yes (dealing in futures contracts) |
| Entering into OTC commodity contracts for differences (whether over one or more commodities) | No |
| Entering into OTC call/put options over commodities (physical delivery) (whether over one or more commodities) | No |
| Entering into OTC call/put options over commodities (cash settlement) (whether over one or more commodities) | No |
| Entering into OTC forwards over commodities (physical delivery) (whether over one or more commodities) | No |
| Entering into OTC forwards over commodities (cash settlement) (whether over one or more commodities) | No |
| Entering into OTC commodity asset swaps, total return swaps, swaptions (whether over one or more commodities) | No |
| 9 Other investments and derivatives | |
| Buying/selling insurance policies | No (although entering into certain investment-linked insurance policies arguably amounts to dealing in securities – limb (b)) |
| Entering into OTC energy derivatives (e.g. over electricity supply/capacity) | No |
| Entering into OTC weather derivatives | No |
| Entering into OTC freight derivatives | No |
| Entering into OTC derivatives over insurance policies | No |
| Entering into OTC derivatives over inflation rates and economic statistics | No |
| Entering into derivatives on derivatives | Maybe, depending on the terms of the particular transaction |

As can be seen from the above table, while many transactions typically executed by hedge funds are within the SFO, many transactions are not, including in particular many interest rate derivatives, credit derivatives, OTC commodity derivatives, deposits, spot

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foreign exchange transactions, borrowing/lending money, insurance contracts and physical commodity trading

3.2 SFO exemptions

As noted in 2 above, there are a series of exemptions from the SFO definitions of "dealing in securities", "dealing in futures contracts" and "leveraged foreign exchange trading". We assume that the Government did not intend these exemptions to apply in relation to these definitions in the context of the profits tax exemption. Otherwise, if the exemptions were to apply, many offshore funds would not, say, be "dealing in securities" (because they were dealing as principal with professional investors, i.e., their brokers), and so could never benefit from the proposed profits tax exemption.

The Government should be asked to clarify that this was not its intention.

4 Transactions through Hong Kong licensed/registered persons

As noted above, one of the requirements for the profits tax exemption is that the relevant transaction must normally be carried out through an appropriately licensed/registered person under the SFO. For example, transactions amounting to "leveraged foreign exchange trading" must be carried out by the offshore fund through (among others) a firm licensed under the SFO for "leveraged foreign exchange trading" or a Hong Kong bank.

While these conditions will often be met, we believe that there will be a number of occasions where they will not be met. For example, many firms in Hong Kong are not regarded as carrying on "leveraged foreign exchange trading" and so do not need to be licensed under the SFO for this activity, because they rely on one of the exemptions (e.g. the exemption under the Securities and Futures (Leveraged Foreign Exchange Trading – Exemption) Rules). An offshore fund will not be able to deal with such firms if it wishes to rely on the proposed profits tax exemption as currently drafted.

Similarly, many brokers in Hong Kong operate as 'introducing brokers' where they introduce business from Hong Kong investors to their offshore affiliates or third-party brokers to execute. In this case, although a Hong Kong licensed person might be involved (at least in passing the investor's order to the affiliate), it may not be correct to say that the transaction has been "carried out through" the Hong Kong broker – it would be more accurate to say that the transaction had been arranged by the Hong Kong broker but had been "carried out through" the offshore broker. The current draft of the exemption may not capture these sorts of arrangements, which we assume was not the Government's intention.

Moreover, the fact that an offshore fund has an SFO licensed asset manager in Hong Kong will not always help either. The way in which "asset managers" are currently brought within the proposed profits tax exemption is by referring to the 'asset manager exemptions' to the activities of "dealing in securities" and "dealing in futures contracts". Unfortunately, these exemptions require that the manager be acting solely for the purpose of carrying on its asset management activity under the SFO, i.e., managing a portfolio of "securities" or "futures contracts". In other words, while this covers transactions in "securities" and "futures contracts" and, arguably, other transactions which are a necessary part of managing a portfolio of "securities" and "futures contracts" (e.g. derivative transactions to manage the risks attached to the portfolio), it would not, in our view, cover unconnected transactions, e.g. commodity derivative transactions, physical commodity trading, etc.

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Indeed we should also point out that some fund managers in Hong Kong do not even need to be licensed for their asset management activities. Where an fund manager provides services to its 100% group companies in relation to the securities and futures contracts owned by those companies, the asset manager is not regarded as carrying on the SFO regulated activity of asset management and so does not need to be licensed for this activity. This is perhaps most often the case in relation to offshore insurance companies which set up a Hong Kong subsidiary to manage the Hong Kong part of the securities/futures contracts portfolio of the offshore insurer. The proposed profits tax exemption would not cover this. In addition, to the extent that the fund manager provides asset management services in relation to other products which do not constitute "securities" or "futures contracts", no "asset management" licence is needed under the SFO in any event. Again, the proposed profits tax exemption would not cover these activities.

Finally, if the exemption is extended to cover additional products not covered by the SFO, the requirement that the relevant transaction be effected through an SFO licensed or registered person (or one of the other limited, permitted categories) no longer makes sense.

5 Suggestions on amending the current draft of the proposed exemption

This section sets out our suggestions as to how the Bill could be amended to extend the profits tax exemption.

5.1 List of products

In addition to the types of investment activity currently permitted under the proposed exemption from profits tax, we believe that the following investment activities should also be allowed:

- spot foreign exchange transactions;
- deposits, certificates of deposit, bills of exchange and promissory notes;
- loans;
- unlisted bonds, debentures or notes issued by Hong Kong private companies;
- credit derivatives;
- interest rate derivatives;
- commodities and OTC commodity derivatives;
- insurance contracts and derivatives over insurance contracts;
- other commonly-traded derivative contracts, e.g. weather derivatives, energy derivatives, etc.

We would also suggest that the Government reserve the power to add to the list, in order to allow it to deal with changing markets, new products, etc.

As transactions in the above products, and indeed certain dealings in securities and futures contracts and leveraged foreign exchange trading under the SFO, are not and are not required to be carried out by or through someone who is licensed under the SFO, we believe that changes would be required to the proposed exemption to cover this.

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We have suggested below some changes to the drafting of the proposed exemption to deal with these issues.

5.2 Suggested drafting

- Section 20AB would need to be amended to include two new definitions used in our amended subsection 20AC(2):

"permitted person" means any person who is licensed, registered or authorised under the laws of Hong Kong or under the law of any place outside Hong Kong to carry on any business involving a permitted transaction, or who is not required under such laws to be so licensed, registered or authorised;"

"permitted transaction" means any transaction involving one or more of the instruments, transactions or activities specified in Schedule [] to this Ordinance;

- We would suggest that subsection 20AC(1)(a) be amended to read:

"(a) transactions falling within subsection (2) that are entered into or performed or otherwise carried out in the year of assessment; and"

- We would suggest that subsection 20AC(2) be amended to read:

"(2) A transaction falls within this subsection if –

(a) the transaction involves a permitted transaction; and

(b) the transaction is entered into with or through or arranged by a permitted person."

- In light of our suggested amendments to subsection 20AC(2), subsections (3) and (4) can be deleted. We also believe that subsection 20AC(5) could be deleted too.

- A new Schedule would need to be inserted to set out the list of permitted transactions. As noted above, this should build on the activities already covered by the Bill (i.e., "dealing in securities", "dealing in futures contracts", and "leveraged foreign exchange trading"):

1. A dealing in securities within the meaning of paragraph (a) or (b) (excluding paragraphs (i) to (xiv)) of the definition of "dealing in securities" in Part 2 of Schedule 5 to the Securities and Futures Ordinance (Cap. 571);

2. A dealing in futures contracts within the meaning of paragraph (a), (b) or (c) (excluding paragraphs (i) to (vii)) of the definition of "dealing in futures contracts" in Part 2 of Schedule 5 to the Securities and Futures Ordinance (Cap. 571);

3. Leveraged foreign exchange trading within the meaning of paragraph (a), (b) or (c) (excluding paragraphs (i) to (xv)) of the definition of "leveraged foreign exchange trading" in Part 2 of Schedule 5 to the Securities and Futures Ordinance (Cap. 571);

4. Foreign exchange trading within the meaning of the definition of "foreign exchange trading" in Part 2 of Schedule 5 to the Securities and Futures

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Ordinance (Cap. 571) (but excluding paragraphs (i) to (xv) of the definition of "leveraged foreign exchange trading" in Part 2 of Schedule 5 to the Securities and Futures Ordinance (Cap. 571));

5. A transaction within the meaning of the definition of "regulated investment agreement" in Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571);

6. A deposit (in any currency) within the meaning of paragraph (a) of the definition of "deposit" in Section 2(1) of the Banking Ordinance (Cap. 155);

7. A negotiable receipt, certificate or document evidencing the deposit of a sum of money (in any currency), or any right or interest arising under or in respect of such receipt, certificate or document;

8. A bill of exchange within the meaning of section 3 of the Bills of Exchange Ordinance (Cap. 19) and a promissory note within the meaning of section 89 of that Ordinance;

9. A loan (in any currency) within the meaning of the definition of "loan" in Section 2(1) of the Money Lenders Ordinance (Cap. 163);

10. A contract of insurance in relation to any class of insurance business specified in Parts 2 and 3 of Schedule 1 to the Insurance Companies Ordinance (Cap. 41);

11. A transaction involving the physical delivery of any commodity;

12. A derivative instrument for the transfer of credit risk;

13. Any debenture, loan stock, bond or note issued by a company that is a private company within the meaning of section 29 of the Companies Ordinance (Cap. 32);

14. Any option, future, swap, forward rate agreement and any other derivative contract that can be settled physically or in cash relating to commodities, contracts of insurance, interest rates or yields, other derivative contracts, a financial index or measure, a climactic variable, freight rates, energy, emission allowances, inflation rates or other official economic statistics, as well as any other derivative contract relating to assets, rights, obligations, indices or measures not otherwise mentioned in this Schedule; and

15. Any transaction, instrument, interest, right or property which is a transaction, instrument, interest, right or property, or is of a class or description of transaction, instrument, interest, right or property, prescribed [by the Financial Secretary by notice under []] for the purposes of this Schedule.

If you have any queries in relation to any part of this memorandum, please let me know.

Stephen Fletcher
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