LC Paper No. CB(1)117/05-06(02)

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

Summary of submissions and Administration's responses
(Position as at 24 November 2005)

	LC Paper No.
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)
Hong Kong Institute of Certified Public Accountants (HKICPA)	CB(1)44/05-06(07)
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 – Taxation Committee (HKGCC(TC))	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)

	LC Paper No.
Hong Kong Venture Capital and Private Equity Association Ltd (HKVCA)	CB(1)44/05-06(17)
The Hong Kong Association of Banks (HKAB)	CB(1)44/05-06(18)
Mr David GUNSON (Gunson)	CB(1)44/05-06(19) & (20)
Goldman Sachs (Asia) L.L.C. (GS)	CB(1)138/05-06(01)
SINOPIA Asset Management (Asia Pacific) Limited (SAM)	CB(1)138/05-06(02)
Deacons (Deacons)	CB(1)172/05-06(01)
Hong Kong Stockbrokers Association (HKSA)	CB(1)172/05-06(02)

CONTENTS

ABBREVIATIONS

CIS	Collective Investment Scheme
CSA	Committee Stage amendment
DIPN	Departmental Interpretation Practice Note
IRD	Inland Revenue Department
IRO	Inland Revenue Ordinance (Cap. 112)
OTC	Over-the-counter
SFC	Securities and Futures Commission
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	Administration's responses
1	***General comments***		
1.1	◆ 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 SAM HKSA	◆ The supportive view is welcomed.
1.2	Strongly welcomes the Bill on the following grounds: ◆ 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	◆ The supportive view is welcomed. ◆ There is no change in IRD's practice. Profits tax would only be charged on trading profits derived from Hong Kong but not capital gains derived from the sale of long-term investments. Though unusual, transactions of a non-resident through a broker or investment adviser, depending on the facts of the case, could amount to the carrying on of a trade and derive trading profits.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
1.3	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.	PWC HKVCA HKGCC(TC)	◆ The supportive view is welcomed.
1.4	◆ 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	◆ The supportive view is welcomed. The policy objective of the current proposal is to provide exemption to offshore funds [i.e. non-resident persons]. Onshore funds [i.e. resident persons] are not entitled to the proposed exemption. ◆ Besides, under s.26A(1A) of the IRO, tax exemption is already allowed to CIS authorized by the SFC and non-SFC authorized funds that are bona fide widely held and complies with the requirements of a supervisory authority within an acceptable regulatory regime.
1.5	◆ Welcomes the Bill and appreciates the efforts of the Government and LegCo to widely consult the industry and the public, and to address the concerns of the industry by refining the Bill to its current form. ◆ Considers that the Bill strikes a fair balance between	GS	◆ The supportive view is welcomed.

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	offering exemption to the intended population and guarding against abuse to protect Government revenue.		
1.6	◆ Supports the Bill in principle. ◆ While the Bill should make the situation more certain for funds that operate primarily outside Hong Kong, it may not give as much assistance to some smaller funds that are locally-operated, in terms of their central management and control, in their efforts to market to offshore investors.	HKICPA	◆ The supportive view is welcomed. ◆ See 2.10 and 2.12 below for the scope of exemption.
1.7	◆ It is an essential feature of international investment funds that they must be tax efficient. If there is even a perception that a fund will be subject to tax in the jurisdictions where it is domiciled, resident or managed, international investors will not invest. It is because the investor may effectively be taxed twice, once when he suffers his share of the tax borne by the fund and once when he is taxed on his disposal of his interest in the fund. The tax borne by the fund affects him indirectly because it reduces the value of his investment. The tax on his disposal obviously affects him directly. It is clear therefore that if the fund is taxed, the investor is better off to invest directly rather than through a fund. ◆ In Hong Kong, it is only Hong Kong sourced profits which are at issue, but overseas investors do not understand that. This misconception discourages overseas investors from investing in Hong Kong managed funds. The growth of the industry has been sustained by the strong assurances from senior government officials that offshore funds would	Deacons	◆ The proposed exemption addresses the concerns of international investors. Offshore funds that are not centrally managed and controlled in Hong Kong will be exempt from profits tax in respect of securities trading transactions carried out in Hong Kong. Further, it is unlikely that an international investor will be liable to tax on his disposal of interest in the fund unless he carries on a trade in Hong Kong which involves the purchase and sale of interest in funds. ◆ Hong Kong maintains the territorial source principle of taxation in that only profits derived from Hong Kong from a business carried on in Hong Kong are subject to profits tax. The Bill will not render an onshore fund liable to tax in respect of profits made by it offshore. The IRD will clarify the position in a DIPN.

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	be exempted from tax. It is essential to the future of the Hong Kong fund management industry that those promises are fulfilled.		
1.8	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.	TIHK Clifford	◆ The current policy objective of the Bill is to provide profits tax exemption for offshore funds. The funds management industry in Hong Kong should also benefit as more offshore funds are attracted to Hong Kong. ◆ As the Bill specifically provides that tax exemption is granted in respect of qualified transactions which are carried out <u>through a licensed corporation or a registered financial institution</u>, the local fund industry should indeed concomitantly benefit from the proposal. Also, the purpose and key of the proposed exemption is to strengthen our competitiveness in order to attract new offshore funds to Hong Kong and encourage existing offshore funds to continue to invest in Hong Kong, and the Bill will achieve this objective. ◆ No other overseas jurisdictions that we are aware of provide profits tax exemption for onshore funds.
1.9	◆ 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	◆ Please see the Supplementary Notes. As illustrated in the various examples set out in Annex A of Appendix I thereto, the current proposal should already provide an adequate and appropriate scope for genuine offshore funds to benefit from the exemption. Further widening the scope of exemption would likely lead to abuse and may open up the exemption to all local funds, which is not in line with the

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			policy intention of giving tax exemption to offshore funds only and would lead to immense financial implications. ◆ Our proposal compares favourably with other international financial centres (IFCs) including Singapore. In Singapore, a foreign company is exempt from tax if it is a non-resident [same as our proposal] and not more than 20% of its issued share capital is beneficially owned by Singapore citizens or residents. The Bill does not have the latter condition and an offshore fund is always exempt from tax in Hong Kong, regardless of the composition of its investors.
1.10	◆ 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	◆ See 1.9 above.
1.11	The Bill is premature, inadequate and ought to be shelved pending further study on overseas experience and input from the private sector.	Gunson	◆ The Administration has made reference to overseas experience in other IFCs, such as the US, the UK and Singapore in drafting the Bill. Moreover, there have been extensive consultations with the industry and interested parties. Most of the industry members we consulted accept the proposed arrangements in the Bill as clarified by the Supplementary Notes. ◆ The exemption currently proposed under the Bill is at a par

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			with, if not better than, those offered by the other jurisdictions. An offshore fund would be allowed exemption by satisfying two conditions – (a) it is a non-resident entity; and (b) it does not carry on another business in Hong Kong consisting of transactions other than the qualified transactions.
1.12	Expresses no comment on the Bill.	LSHK	◆ Noted.
2	***Clause 2 – proposed section 20AB – Interpretation of sections 20AC, 20AD and 20AE and Schedule 15***		
	Concepts of "resident" and "non-resident"		
2.1	◆ 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	◆ The policy objective is to provide exemption to "offshore" funds, <u>not</u> to "all" funds and <u>not</u> to "onshore" funds. A distinction must be made between offshore funds and onshore funds. The current proposal adopts the international practice of distinguishing offshore funds from onshore funds by reference to the fund's [i.e. the relevant entity's] residency status.
2.2	◆ The preferred approach would be to apply the exemption from profits tax depending upon the location of the investors in the fund without regard to the residency of the fund itself.	HKICPA BCC	◆ The mentioned approach was in fact proposed when the Administration first consulted the industry in 2003. The approach was eventually not adopted because of the industry's concern about the virtual impossibility for the funds to trace and determine the residency status of their ultimate investors.
2.3	◆ The concept of residence does not sit well with the territorial concept of taxation. The Administration should	TIHK Clifford	◆ Hong Kong maintains the territorial source principle of taxation in that only profits derived in Hong Kong from a

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	minimize invoking this concept in the Bill. There are three points of concern or suggestions: (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 application of an otherwise highly subjective test.		business carried on in Hong Kong are subject to profits tax. ◆ The proposed residency test would determine whether a certain entity could get the profits tax exemption proposed in the Bill. If it is not so exempted, its tax liability would still be determined by the territorial source principle. ◆ As noted above, the "central management and control" test is a well-established common law principle widely adopted in many jurisdictions in determining residence of non-individual entities. Marginal cases may arise for every legal test. This does not mean that a particular legal test is undesirable or ineffective. ◆ The IRD plans to issue a DIPN to explain the criteria to be adopted to determine whether a fund is centrally managed and controlled in Hong Kong. ◆ It can be easily arranged to incorporate a corporation outside Hong Kong. The Administration considers that the place of incorporation is not an appropriate test to determine whether a fund is an offshore fund. Moreover, if this simple "incorporation" test is adopted for defining "residency", there would likely be abuses with the end result that all corporations' securities trading profits would be exempt from tax by being incorporated overseas. ◆ The management structures and operations of different entities can be very different. It is not possible to design a standard questionnaire that is suitable for determining the residence of all entities. On the other hand, the relevant

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
			legal tests are well established and clearly laid down by case law. ◆ There are existing examples of utilizing the residency concept in conjunction with the territorial concept in administering the IRO. For example, under section 20A, a non-resident person [whose residency status is determined by the well-established common law principles] who has profits arising in or derived from Hong Kong [as determined by applying the territorial concept] may be charged to tax in respect of such profits in the name of his agent in Hong Kong.
2.4	Expresses concern that the Bill would imply a change of taxation regime from a source-based to a residency-based regime.	Gunson	◆ The enactment of the Bill would not impose any changes to the territorial taxation regime operated by Hong Kong. The Bill proposes to exempt non-residents from profits tax in respect of securities trading profits derived from Hong Kong. Offshore profits all along are and would continue to be not chargeable to profits tax without involving the provisions proposed under the Bill. ◆ When proposing the CSA to widen the scope of the exemption (see paragraph 3.1 below), the opportunity will be taken to state clearly that only "assessable profits" would be exempted under the proposed section 20AC. ◆ The proposed exemption is targeted at non-residents. Residents are not allowed to take benefit from the exemption. The residency test under the Bill is necessary to identify non-residents who would be entitled to the exemption. Such residency test would only apply

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			in administering the proposed exemption.
2.5	◆ 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	◆ Appropriate legal tests must be adopted in administering the proposed exemption. The residency and "central management and control" criteria proposed under the Bill are consistent with widely accepted international practices. Under the current policy objective, an onshore fund, whose central management and control is exercised in Hong Kong, should not be entitled to the proposed exemption. ◆ There is a substantial body of case law illustrating how the courts have interpreted the concept of "central management and control".
2.6	◆ 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	◆ The Administration believes that there should not be any difficulty in determining the residency status of an individual. ◆ For a corporation, a partnership and a trustee of a trust estate, the definition of "non-resident" by reference to the "central management and control" test is fair and reasonable having regard to international practice in this respect.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
2.7	◆ 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 illustrated by the following examples: (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. (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. ◆ 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 residency 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	ACCA	◆ The residency test for an individual has been used in the IRO for decades. It allows an individual to apply for personal assessment if he is a permanent resident or a temporary resident during the year in question. In such way, he is entitled to claim for personal allowances and can reduce his tax liabilities as a result. The same test is used in the Double Taxation Agreements which Hong Kong makes with other countries/tax jurisdictions, e.g. Belgium and Thailand. It is therefore preferable to align the definitions of an individual's residence in the proposed Bill. ◆ Although the individual investor in example (b) would be regarded as a resident in the year 2005/06 and hence liable to tax on his share dealing profits derived from Hong Kong, he at the same time qualifies for personal assessment for that year by virtue of his temporary residence. ◆ Paragraph 10 of the Supplementary Notes did not say that split year residence is allowed for a fund. It only says that a fund may change its residency status during a year of assessment, i.e. from non-resident to resident or vice versa. However, the residency status will be determined on a *year of assessment basis* by reference to the respective periods during which the fund is or is not resident in Hong Kong. Therefore, the section 20AB(2)(a)(ii) as quoted would not disadvantage an individual investor by not allowing split year residence.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	the fund changes its residency 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.		
2.8	◆ 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	◆ For the purpose of the proposed exemption, the residency status of a person in a year of assessment is determined by reference to the year as a whole. Where there are changes of circumstances during the year, the respective periods in the year will be looked at and the residency status of the person in that year as a whole will then be determined accordingly. ◆ It follows that if such a company is adjudged to be resident in Hong Kong during the year in question, the proposed profits tax exemption would not be applicable to the company during the year.
2.9	◆ Section 20AB(2)(a) set out the definition of a resident person where the person is the natural person. ◆ There are two tests currently used by the IRD for different purposes under the IRO to determine the number of days spent by a person in or out of Hong Kong. Under the circumstances, the test for determining days in or out of Hong Kong under the proposed section 20AB(2) needs to be made clear.	HKICPA	◆ The IRD will clarify in a DIPN the method of counting the number of days for the purposes of the Bill. Part day will be counted as one day for the purposes of the Bill. This is in line with the practice taken for the purpose of the 60-day rule for salaries tax [s.8(1B)], for election of personal assessment [s.41], and for determining residency for tax treaty purposes.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	Concept of central management and control		
2.10	◆ 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: (a) The exemption provisions would appear to cover only the following types of funds - (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 exemption under the	Ernst & Young	◆ It is correct that only funds under paragraph (a)(i) and (ii) would be exempt under the proposed Bill. ◆ The current proposal reflects the policy of attracting foreign capital from non-residents to invest in Hong Kong's financial market by allowing tax exemption to non-residents in respect of securities trading profits. Allowing tax incentive to the fund management industry in Hong Kong per se is a matter separate from and not intended by the current proposal. ◆ As noted above, the Administration considers that the current proposal should already provide an adequate and appropriate scope for genuine offshore funds to benefit from the exemption.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	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. ◆ Strongly advocates extending the proposed exemption to funds that are centrally managed and controlled in Hong Kong for the following reasons - (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.		
2.11	◆ 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	◆ The "central management and control" concept is a common law principle that is derived from case law and court decisions. It is a question of fact and not capable of being defined exhaustively. However, there is a substantial body of case law that helps illustrate how the courts have interpreted this concept and how the concept has been applied to factual situations.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
			◆ The fact-finding process would be an objective one. An aggrieved taxpayer can always raise objection with the Commissioner and appeal to the courts. ◆ As noted above, the IRD plans to issue a DIPN to explain the criteria to be adopted to determine whether a fund is centrally managed and controlled in Hong Kong.
2.12	◆ 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. ◆ 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: (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	HKSFAL	◆ The policy objective is to provide exemption to "offshore" funds, <u>not</u> to "all" funds and <u>not</u> to "onshore" funds. A distinction must be made between offshore funds and onshore funds. The current proposal adopts the international practice of distinguishing offshore funds from onshore funds by reference to the fund's [i.e. the relevant entity's] residency status.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	as a leader in the global financial industry.		
2.13	◆ 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: (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 located where the majority of its board meetings take place, provided that the circumstances do not indicate an artificial or contrived outcome. (c) Central management and control involves the high level decision making processes, including activities	DTT	◆ The "central management and control" test is a well-established common law principle adopted in many jurisdictions in determining the residency of non-individual entities. The location where central management and control is exercised is wholly a question of fact and each case must be decided on its own facts. There is a considerable body of case law on this subject to guide its operation. It is well settled that the central management and control refers to the highest level of control of a business. Hence, it is not necessary and may not be possible or appropriate to set out in the Bill exhaustively the circumstances under which the central management and control of an entity is regarded as being exercised in Hong Kong. Indeed, jurisdictions (such as Australia, the UK and Singapore) that adopt the same concept for determining the residency for tax purposes also do not define the scope of the concept in their statutes. ◆ The IRD will issue a DIPN to explain how the provisions of the Bill are to be applied, including the "central management and control" test with worked examples. ◆ In preparing the DIPN, the IRD will take overseas tax cases and practices into account.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	involving high level company matters such as general policies and strategic directions, major agreements and significant financial matters.		
2.14	◆ 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	◆ See 2.13 above.
2.15	The IRD should issue a practice note specifying the application of the "central management and control" tests.	TIHK Clifford	◆ IRD will issue a practice note as noted above.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
2.16	◆ 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	◆ Following the well-established common law rule, which has been adopted in many countries, the IRD considers that the central management and control of a company refers to the highest level of control of the business of a company. ◆ The IRD will incorporate examples in a DIPN to clarify matters concerning "central management and control".
2.17	◆ 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	◆ The "central management and control" test is a well-established common law principle adopted in many jurisdictions in determining the residency of non-individual entities. The location where central management and control is exercised is wholly a question of fact and each case must be decided on its own facts. There is a considerable body of case law on this subject to guide its operation. It is well settled that the central management and control refers to the highest level of control of a business. Hence, it is not necessary to set out in the Bill exhaustively the circumstances under which the central management and control of an entity is regarded as being exercised in Hong Kong. Indeed, jurisdictions (such as Australia, the UK and Singapore) that adopt the same concept for determining the residency for tax purposes also do not define the scope of the concept in their statutes. The IRD will issue a DIPN to explain how the provisions

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
			of the Bill are to be applied, including the "central management and control" test with worked examples.
2.18	◆ 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	◆ See 2.17 above. The Administration does not see it appropriate to include a definition for "central management and control" in the Bill. The principle is not statute law but was developed by case law. Central management and control is a question of fact and different modes of business operation may evolve over time. A statutory definition may hinder the application of the common law principle to vastly different real life situations and may also not be flexible enough to accommodate future changes.
2.19	◆ 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	KPMG	◆ See 2.13 above. ◆ The IRD considers that the central management and control of a company refers to the highest level of control of the business of the company. In general, if the central management and control of a company is exercised by the directors in board meetings, the relevant locality is where those meetings are held. As central management and control is a question of fact and reality, when reaching a conclusion in accordance with case law principles, only factors which exist for genuine commercial reasons will be accepted. ◆ It seems that the approach adopted by Singapore has been misstated. Under the Singapore approach, an offshore fund would only get exemption if two conditions are satisfied: (a) the offshore fund itself is a non-resident entity [i.e. same as the current proposal]; and (b) 80% or more of

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	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.		the value of the fund is held by non-residents. ◆ The former approach proposed in the First Consultation Paper in fact was similar to the approach adopted by Singapore. The approach was eventually not adopted because of the industry's concern about the virtual impossibility for the funds to trace and determine the residency status of their ultimate investors.
2.20	◆ Introducing the concept of "central management and control" into the legislation and determining the residency of a corporation, partnership and trustee of a trust estate by reference to this concept, without defining it more specifically, would add complexity and uncertainty to the territorial taxation system in Hong Kong, and result in the need for complicated fact-finding. ◆ The central management and control test in some cases could discourage funds from employing Hong Kong-based fund managers or from relocating fund managers to Hong Kong. ◆ There is no definition or clarification in the Bill as to how "central management and control" is to be determined. This could lead to disputes in determining whether such a person is centrally controlled and managed, and so resident, in Hong Kong.	HKICPA	◆ See 2.11, 2.12 and 2.13 above.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
2.21	◆ 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. ◆ Welcomes the Administration's proposal to issue a DIPN to provide guidance in the interpretation and application of the concept of central management and control.	HKAB GS	◆ The IRD will issue a DIPN to clarify matters involving "central management and control". The DIPN will incorporate examples similar to those in the Supplementary Notes to explain how the "central management and control" test should be applied.
2.22	◆ The definition of "non-resident persons" should not be too narrowly defined, and, as far as possible simple to apply, so as to avoid uncertainty. ◆ While a high-level definition of "management and control" appears to provide such comfort, suggests avoiding to enshrine it into the Bill, so as to leave room and time to the IRD to account for specific issues and practice. ◆ A statement from the IRD based on past experience as well as new practice under the Bill could suffice and possibly provide more flexibility.	SAM	◆ The IRD plans to issue a DIPN to explain the criteria to be adopted to determine whether a fund is centrally managed and controlled in Hong Kong. See further details in 2.3 above.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
2.23	◆ 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	◆ This point is agreed. ◆ See 2.17 and 2.18 above. It is not practicable to provide a definition of "central management and control" in the Bill.
2.24	◆ 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(TC)	◆ See 2.23 above.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
2.25	◆ Seeking to address the concern about the central management and control test through the DIPN could compound the uncertainty. In the context of DIPN No. 10, for example, which relates to the charge to salaries tax under section 8 of the IRO, the concept of central management and control is also used in considering whether an employer is resident outside Hong Kong. However, in practice, it seems that sometimes having a "place of residence" has been regarded as being sufficient to satisfy the test of central management and control. Thus, overseas companies that operate a branch in Hong Kong, even though their head office and substantial operations may be located outside Hong Kong, may be treated as falling within the definition of being resident in Hong Kong.	HKICPA	◆ The comparison to DIPN No. 10 is not appropriate. The residency of an employer is merely one of the factors in deciding the source of income chargeable to salaries tax under section 8 of the IRO. The IRD has made clear in DIPN No. 10 that it would, in appropriate cases, look beyond the three factors (i.e. contract of employment, residency of employer and place of payment of remuneration) mentioned therein. In contrast, the place of central management and control is the only factor determining the residency status of a person (other than a natural person) for the purposes of the Bill.
2.26	◆ Suggests that the key concepts of residence and central management and control, should, as far as possible, be clarified in the legislation and should not be left to be determined simply by reference to practice. ◆ The Supplementary Notes indicate that the central management and control of a company refers to the highest level of control of the business of the company. It is for consideration whether the definition of central management and control of a company should, for example, refer to the place where the directors hold their board meetings or, in the case where the directors have delegated effective control of the business to one or more directors, the place where the director(s) exercises that power.		◆ See 2.11 and 2.13 above.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
3	***Exemption provisions – clause 2: proposed sections 20AC, 20AD***		
	Qualified transactions under the Bill		
3.1	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: ◆ 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. ◆ As new financial products develop, transactions in theses new products might fall outside the scope of exemption.	CPA	◆ To administer the exemption, a scope of exemption has to be imposed. Exemption cannot be allowed by reference to "transactions that an offshore fund might wish to carry out", as the term is too wide and imprecise. ◆ As a matter of policy, certain transactions, including those in shares in private companies, are explicitly excluded from the exemption. ◆ The Bill currently sets out that exempt transactions include "dealing in securities", "dealing in futures contracts" and "leveraged foreign exchange trading" [respectively Type 1, 2 and 3 Regulated Activities under the SFO]. "Securities" is widely defined in general terms under the SFO, which should cover most of the market activities carried out by a typical offshore fund. Also, since the definition is in general terms and in some instances quite generic, it should be able to cover new financial products of similar nature. ◆ The Administration, however, agrees to examine whether the scope of exempt transactions is wide enough and whether government officials should be empowered to recognize new financial products from time to time for the purposes of the exemption. The Administration will move CSAs to suitably relax the scope of exemption and to empower a government official to amend the scope to take

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
			into account future changes in the market. ◆ "Passive income" such as dividend or interest from bank deposit is already exempt from tax under the existing law. Trading income from "incidental transactions", subject to the 5% de minimis rule, is exempt from tax.
3.2	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.	Ernst & Young	◆ See 3.1 above. The Administration will move CSAs to suitably relax the scope of exemption.
3.3	◆ 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 derivates (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	◆ As a matter of policy, shares in private companies are explicitly excluded from the exemption. A person may in effect trade in any types of assets [e.g. landed property] through transfer of shares in private companies purposely set up for holding such assets. The inclusion of private shares would unintentionally widen the scope of exemption. ◆ As noted in 3.1 above, the Administration will move CSAs to suitably relax the scope of exemption.
3.4	◆ 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.	HKSFAL	◆ See 3.3 above.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	◆ Urges the Government to consider the above concern either in the wording of the tax law, or in the implementation of the law.		
3.5	◆ Welcomes a broader definition of "securities". Two suggestions for amending the definition, as follows: (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, including interest rate derivatives, credit derivatives, OTC commodity derivatives, spot foreign exchange transactions, borrowing/lending money, and physical commodity trading (please see proposed legislative wordings in Ref. 2 in Appendix A). ◆ 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.	DTT	◆ See 3.3 above.
3.6	◆ 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.	AIMA PWC	◆ CSAs will be moved to extend the scope of qualifying transactions and specified persons. The certainty called for would be addressed by the CSAs.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	◆ 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.	PWC	
3.7	◆ 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 adding new schedules.	HKAB	◆ "Securities" is widely defined in general terms under the SFO, which should cover the market activities carried out by a typical offshore fund. As noted in 3.1 above, a CSA will be moved to widen the scope of the term where considered necessary.
3.8	◆ 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.	HKIFA	◆ The Administration will move CSAs to suitably relax the scope of exemption.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	◆ 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.		
3.9	◆ 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	◆ See 3.7 above. As a matter of policy, shares in private companies are explicitly excluded from the exemption. A person may in effect trade in any types of assets [e.g. landed property] through transfer of shares in private companies purposely set up for holding such assets. The inclusion of private shares would unintentionally widen the scope of exemption.
3.10	The exemption provisions may be too narrow in defining "qualified transactions" such that over-the-counter transactions and investments in private pre-ipo equity are not exempted.	HKSA	◆ See 3.9 above.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
3.11	◆ 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, borrowing and lending money, etc. ◆ 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. *(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).*	CMTCA	◆ See 3.9 above.
3.12	◆ Many offshore funds engage in other types of transactions not covered in the Bill. ◆ In reviewing the scope of proposed exemption, it is important that flexibility be built into the definition to cope with market developments without the need for any legislative amendments (e.g., "any other transactions that the Commissioner of Inland Revenue may in writing allow").	GS	◆ See 3.1 above.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
3.13	◆ The scope of exemption appears to be too narrow. OTC derivatives, commodities, private equity and various sorts of commonly used fixed income or quasi fixed-income investments (e.g. cash deposits, debentures) seem to be excluded. ◆ The restricted definition may hamper the development of new generation investment products, typically "Alternative investments" and "Total returns funds", which make extensive use of such investment tools.	SAM	◆ See 3.1 above.
3.14	It would be preferable to include shares in private companies within the scope of exemption.	BCC	◆ As a matter of policy, shares in private companies are explicitly excluded from the exemption. A person may trade in any types of assets through transfer of shares in private companies purposely set up for holding such assets. Inclusion of shares in private companies in effect would grant exemption to all sorts of trading transactions.
3.15	◆ Welcomes the Administration's undertaking to re-examine the scope of qualified transactions. ◆ It is reasonable to include shares in private companies within the scope of qualified transaction, with exception for those companies that hold predominantly immovable property in order to address the Administration's concern about possible abuse of the exemption provisions through injection of immovable/landed properties into private companies.	HKICPA	◆ See 3.14 above.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	Qualified transactions carried out through specified persons		
3.16	◆ 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	◆ The policy objective of the proposed exemption is to attract foreign capital from non-residents to invest in the local market by carrying out securities transactions in Hong Kong. It may not be appropriate to extend the exemption to cover transactions carried out in foreign markets through persons regulated by overseas legislation. ◆ The position of transactions executed by third party agents or brokers upon the instruction of the authorized persons would be considered together with the widening of the meaning of "securities" as appropriate.
3.17	◆ 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 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. ◆ Suggests that the list of specified persons be expanded, as follows- (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	CMTCA	◆ Under the current proposal, exemption would only be allowed to an offshore fund if all its qualified transactions and incidental transactions are carried out through licensed corporations or registered institutions under the SFO.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	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. *(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).*		
3.18	◆ 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 GS	◆ This proposal has been adopted in the CSAs.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	Incidental transactions		
3.19	◆ 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	◆ It may not be suitable to impose a definition on "incidental". It would be difficult to arrive at a definition that can cover all possible modes of operation adopted by different offshore funds. The word "incidental" would be accorded its common meaning, which should provide the desired flexibility to different offshore funds. ◆ It may be equally difficult to define precisely "transactions commonly engaged by funds which should be deemed as incidental transactions". That said, generally speaking, a fund which engages in activities in the ordinary course of its business would unlikely be regarded as operating a separate business thus flouting the exemption that it would otherwise enjoy.
3.20	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: (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	DTT	◆ It may not be suitable to impose a definition on "incidental". It may be equally difficult to define "transactions commonly engaged by funds which should be deemed as incidental transactions". See 3.19 above for further details. ◆ It is common in other tax jurisdictions (e.g. Singapore) to require an offshore fund not to carry on "other business", since the carrying on of other businesses is not compatible with the ordinary course of business of an offshore fund. Therefore, the Administration does not support the proposal to remove the distinction between "incidental transaction" and "other business". The scope of exemption will be suitably relaxed (see 3.1

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	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 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. (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).		above). The 5% threshold is considered reasonable.
3.21	◆ 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	ACCA	◆ An incidental transaction would not fall within the definition of "qualifying transaction" [otherwise, it qualifies as a qualifying transaction]. Therefore, it is

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	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).		incidental to but does not form part and parcel of a qualifying transaction. ◆ Allowing the "5%" exemption in respect of incidental transactions would provide operational convenience to offshore funds for not being required to report small amount of otherwise taxable income in respect of incidental transactions.
3.22	◆ 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 exempt transactions and incidental transactions put together. ◆ Seeks clarification on the following issues: (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	HKIFA	◆ See 3.6 above. The widened definition of "qualifying transactions" would alleviate the concern. ◆ The IRD will clarify in the DIPN that non-taxable items, e.g. dividends, bank deposit interest, will not be regarded as incidental income.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	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".		
3.23	◆ 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	◆ The relevant provisions in the Bill as currently drafted have the legal effect of providing exemption in respect of qualifying transactions even if gross receipts from "incidental" non-qualifying transactions exceed 5% of the total trading receipts from all transactions. ◆ The IRD will clarify this point in the DIPN if necessary.
3.24	◆ 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.	ACCA	◆ The proposed exemption would be allowed by reference to the residency status of an entity and that the entity does not carry on other business in Hong Kong. ◆ Administering the exemption by reference to the source of "funds" [i.e. moneys] is impractical and open to abuse. In real life situations, business "funds" are commonly

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	◆ 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.		pooled and become mixed before actual application. Earmarking the source of "fund" is an artificial and elusive process and subject to manipulation.
4	***Deeming provisions- clause 2: proposed section 20AE***		
	Application of the deeming provisions		
4.1	◆ 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: (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.	Ernst & Young	◆ Insofar as a resident individual who carries out share transactions in Hong Kong in his own name is concerned, there is no difference in his tax position before and after enactment of the Bill. ◆ Before the enactment of the Bill, a resident individual is not chargeable to tax in respect of profits from share transactions carried out in his own name insofar as those transactions do not amount to the carrying on of a business. After the enactment of the Bill, the same tax position remains. Further, the Deeming Provisions would not apply to the resident individual who continues to carry out in his own name share transactions which do not amount to the carrying on of a business. ◆ The Administration considers that there is little justification for giving the preferential tax treatment to

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	(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 exempt fund should remain with the deeming provisions by reason that he/she could be regarded as being closely connected with the securities industry. The deeming provisions should apply to the resident individuals who are associated with exempt funds, with the exception of individuals, who, as the holders of management shares, are not entitled to participate in the fund's profits or in any distribution of the fund's assets upon dissolution, other than a return of capital.	HKICPA	individuals. Beneficial interests in corporations are ultimately held by individuals. A different tax treatment for individuals would create tax-avoidance opportunity. ◆ The Administration will move a CSA to carve out management shares from the application of the Deeming Provisions (see paragraph 23 of the Supplementary Notes).
4.2	◆ 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	◆ See 4.1 above.
4.3	◆ Currently, Hong Kong residents are not subject to profits tax in respect of investment income derived from onshore	KPMG	◆ See 4.1 above.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	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.		
4.4	◆ 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	ACCA	◆ The Administration has carefully considered this point. We however maintain the view that administering of the Deeming Provisions by reference to the source of funds is impractical and open to abuse. Please see paras. 31 & 32 of the Supplementary Notes. Since business funds are commonly pooled together and become mixed before actual application, earmarking the source of funds (i.e. moneys) is an artificial, difficult and onerous process and subject to manipulation. Furthermore, similar exemptions of other jurisdictions are by reference to the residency of the entities rather than the source of funds (i.e. moneys).

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	strategy of the overseas subsidiary) should be provided with an escape clause from the deeming provision.		
4.5	◆ 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: (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. (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.	AIMA	◆ See 4.4 above.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
4.6	◆ 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	◆ See 4.4 above.
4.7	◆ 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	◆ See 4.1 above.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
4.8	◆ 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 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: (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. (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. (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	HKGCC(TC)	◆ Hong Kong maintains the territorial source principle of taxation in that only profits derived from Hong Kong from a business carried on in Hong Kong are subject to profits tax. ◆ The residency concept in conjunction with the territorial concept in fact is currently adopted in administering the IRO. Under the existing provisions, a non-resident person [whose residency status is determined by the well-established common law principles] who has profits arising in or derived from Hong Kong [as determined by applying the territorial concept] may be charged to tax in respect of such profits in the name of his agent in Hong Kong. ◆ General anti-avoidance provisions in the IRO are not easy to apply, especially when a resident investor does not have a controlling interest in the tax-exempt offshore fund. There are many [up to seven] factors to consider before the general anti-avoidance provisions can be applied. On the other hand, there are only two factors to consider for the deeming provisions [i.e. the "threshold" and "associate" tests]. ◆ Hong Kong based groups should not have great difficulty in obtaining information on the business operation of its overseas subsidiaries. The holding company, whether for legal, accounting or other commercial reasons, should always possess sufficient business information on its subsidiaries for meeting requirements under the deeming

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	compliance burden has been discounted by the Administration but will represent a real cost to Hong Kong taxpayers. ◆ Urges the Bills Committee to either reject the deeming provision or amend the Bill to address the concerns.		provisions. ◆ The proposed exemption is targeted at non-residents. The deeming provisions and the "associate" test have to be enacted to deter residents from carrying out round-tripping, i.e. residents disguised as non-residents to take advantage of the exemption, which is not intended for them. The Administration reiterates that the deeming provisions are necessary to prevent abuse of the exemption provisions.
4.9	The application of the deeming provisions is too broad and may have an unintended consequence of widening the tax net.	HKSA	◆ See 4.1 and 4.4 above
	Triggering threshold – proposed section 20AE(2)		
4.10	◆ It is conceptually difficult to justify the use of a 30% threshold for triggering the deeming provisions. ◆ 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	TIHK Clifford	◆ In principle, a resident investor under the Bill should be chargeable to tax in respect of *any* securities trading profits he derived from Hong Kong through holding *any* percentage of beneficial interest in a tax-exempt offshore fund. ◆ The Administration is aware of the difficulty a resident investor may have in obtaining information if he only holds a small interest in an offshore fund. However, the Administration must strike a balance between revenue protection and the practicality of complying with the reporting requirements by resident investors. ◆ A 30% beneficial interest in an offshore fund is quite substantial. A resident investor should not have great

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	threshold should be calculated.		difficulty in obtaining information from an offshore fund if he holds a 30% interest in it. ◆ The Bill defines beneficial interest in a corporation by reference to the "issued share capital (however described) of the corporation". If necessary, guidance on how the triggering threshold should be calculated will be included in the DIPN.
4.11	◆ 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	◆ See 4.10 above.
4.12	◆ 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	ACCA	◆ See 4.10 above.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	proposed subsection 20AE(1) will only apply to situation if the resident, on his own or together with associates, has control over the non-resident investment.		
	The term "associate" — proposed section 20AE(3) and (10)		
4.13	◆ 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: (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	◆ The term "associate", if too narrowly defined, would be unable to serve the intended anti-avoidance purpose. It can be envisaged that a narrowly defined "associate" could be easily circumvented and thus render the Deeming Provisions redundant. ◆ A fund manager holding beneficial interest in a fund is no different from a resident investor; in fact he may be even more closely connected with the securities business. Accordingly, the associate rules should apply to a fund manager as with any other resident investors.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
4.14	◆ 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 wordings in the proposed section 20AE(3) to resolve this issue (please see the proposed legislative wordings in Ref. 4.4 in Appendix A).	DTT	◆ The drafting of the "associate" provisions is consistent with the other similar provisions in the IRO. No adjustment is necessary.
4.15	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	◆ The term "associate", if too narrowly defined, would be unable to serve the intended anti-avoidance purpose. It can be envisaged that a narrowly defined "associate" could be easily circumvented and thus render the Deeming Provisions redundant.
4.16	The definition of "associate" is too complicated and should be simplified.	CPA	◆ See 4.15 above.
	Concern about double taxation		
4.17	The drafting of the deeming provisions will create tax liabilities on individuals who trade in Hong Kong securities. There are	CPA	◆ See 4.1 above. There would be no difference in the tax position of an individual who carries out share

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	two points of concern: ◆ 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.		transactions in his own name after enactment of the Bill. The Deeming Provisions would not apply to the individual who continues to carry out securities transactions, other than by way of a trade or business, in his own name.
4.18	◆ 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	◆ Double taxation generally refers to the situation where the same profit is taxed twice in the hands of the same person. This should not arise in the scenario highlighted. ◆ Where a person holds shares in, say, a Hong Kong listed company and makes a profit from the sale of the shares, he would pay tax on the profit only if the profit is revenue in nature (i.e. the profits are derived from a trade or business rather than investment). The listed company would separately pay tax on any share dealing profit it derives. The listed company's share dealing profit is distinctly different from the profit derived by the person from the sale of the shares in the listed company. No double taxation should arise. ◆ Where the Deeming Provisions apply to a resident person, the resident person would pay tax on a portion of the share dealing profits earned by the offshore fund. This is the tax that should have been paid by the offshore fund but for the exemption and also is distinct from the tax, if any, charged on the profits derived by the resident person from the sale of units in the offshore fund. Similarly, there is

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
			no double taxation. ◆ Further, Hong Kong does not tax dividends and capital gains. The profit derived from the sale of units in an offshore fund is not taxable if the units are held for investment purposes.
4.19	◆ 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 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.	BCC	◆ See 4.18 above. ◆ There are many factors affecting share prices and these factors are in force concurrently at any given point in time. Therefore, it is not possible to attribute share price movements to any particular factor such as a tax paid.
4.20	◆ 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.	DTT CPA	◆ The crux of the matter is the levying of tax in a foreign jurisdiction on the securities dealings profits made by an offshore fund in Hong Kong. ◆ Allowing tax credit to a resident person as proposed would amount to giving up Hong Kong's taxing right on profits sourced from Hong Kong, which is against the basic principle in the perspective of avoidance of double taxation

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	◆ Two options for addressing the issue, as follows: (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.	DTT	and against the international practice for a source jurisdiction to exercise its taxing right. Therefore, there is no question of allowing such a tax credit, which is given by a jurisdiction to its residents in respect of profits derived offshore but are taxed both overseas and locally.
4.21	◆ 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. ◆ 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	KPMG	◆ See 4.18 above. ◆ The purpose of the Deeming Provisions is to recoup tax properly chargeable on a resident who carries out round-tripping in respect of securities trading transactions carried out by a tax-exempt offshore fund. Besides, a fund generally would declare and distribute profits to its shareholders/beneficiaries at around the same time as it finalizes its annual accounts, and that would be the same time as the Deeming Provisions would also operate requiring the resident to report profits to the IRD. Further, the anti-avoidance purpose of the Deeming Provisions may not be achieved if they are only

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	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: (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.		invoked after a resident has received distributions from an offshore fund. It is because an offshore fund may decide to defer distributions or even decide not to pay any distribution at all, which would render the Deeming Provisions inoperative.
4.22	◆ 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 where the non-resident person is also subject to tax imposed by	HKGCC(TC)	◆ See 4.18 and 4.20 above.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	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.		
4.23	◆ 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 sells the shares in the fund. This would appear to be a form of de facto double taxation. ◆ With reference to the example given in paragraph 25 of the Administration's Supplementary Notes, there is a difference between the application of the deeming provisions and the situation in which a resident sells shares in a listed company. Where a resident investor pays tax on the gain on the disposal of shares in a listed company, the sale price of the shares would reflect any 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 realizes a gain on the disposal, double taxation would apply.	HKICPA	◆ See 4.19 above
	Other concerns on the deeming provisions		
4.24	◆ 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	CPA	◆ The policy objective of the proposed exemption is to attract foreign capital from non-residents to invest in the local financial market. A resident person should be discouraged from carrying out round-tripping [i.e. carrying

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	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.		out share dealing transactions through non-resident persons]. ◆ The Deeming Provisions, together with disallowing deemed loss, are intended disincentives to resident persons from carrying out round-tripping. Otherwise, a resident person carrying out round-tripping would find himself to be at a par with another resident person who does not carry out round-tripping.
4.25	◆ 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	◆ A loss made by a non-resident person will not be attributed to a resident investor. See 4.24 above.
4.26	◆ 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 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	BCC	◆ If an offshore fund is not exempt in any particular year of assessment, the loss it sustains in that year will be available for set off against its taxable profits in any subsequent years of assessment. As such, an un-exempt offshore fund is treated in the same way as any other business in Hong Kong. ◆ The Deeming Provisions, together with disallowing

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	offset any losses that may arise.		deemed loss, are intended disincentives to resident persons from carrying out round-tripping.
4.27	◆ Expresses doubt whether it is appropriate to deny a resident investor a deemed loss to set off against other taxable profits, where an offshore fund makes a loss over the year. ◆ Considers that Hong Kong residents caught by the deeming provisions should be able to claim a tax loss. ◆ Suggests that expenses incurred by a resident investor in generating the deemed profits should be deductible in computing the profits chargeable on the resident investor.	HKICPA	◆ See 4.26 above. ◆ In respect of the deductibility of expenses incurred by a resident investor in generating the deemed profits, the Administration considers that no such deduction should be allowed. The expenses incurred by the offshore fund in earning the securities trading profits derived from Hong Kong would have been deducted in ascertaining the deemed profits to be imposed on the resident investor.
4.28	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	◆ The supportive view is welcomed.
5	***Retrospective application of the Bill (proposed section 20AC(1))***		
5.1	It is encouraging to find that the Bill will have retrospective effect from 1 April 1996.	AIMA	◆ The supportive view is welcomed.
5.2	Strongly supports the retrospective application of the exemption provisions.	PWC	◆ The supportive view is welcomed.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
5.3	Strongly supports the retrospective application of the exemption provision. There is a real need for such a provision for the following reasons: ◆ 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 - (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. (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. (c) Significant investments are made into Hong Kong by	HKIFA	◆ The supportive view is welcomed.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	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. (d) CISs would face very difficult valuation issues as their auditors would have to consider potential liabilities for back years.		
5.4	◆ Welcomes the retrospective application of the Bill from an industry standpoint. ◆ Sees the proposal a logical and fitting conclusion to a period during which the industry are told the IRD has in practice not taxed foreign funds using Hong Kong investment managers.	SAM	◆ The supportive view is welcomed.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
5.5	◆ 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	◆ All along, any fund which derives securities dealing profits from Hong Kong is chargeable to profits tax in Hong Kong. The IRD has the statutory duty to recover tax from any persons who are liable to pay tax under the provisions of the IRO. ◆ The proposed retrospective provisions do not impose a new tax obligation on the funds. For those funds that satisfy the exemption criteria, these provisions would exempt them from tax liabilities retrospectively; for others that do not satisfy the exemption criteria, such provisions would not help in the circumstances and the existing law applies (i.e. no new tax liability will be created). Therefore, there should not be any problem for the retrospective action to take effect from 1st April 1996.
6	***Schedule 15 – provisions for ascertaining amount of assessable profits of resident person under section 20AE***		
6.1	◆ 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 exit a fund making gain or loss at any time during the year. ◆ 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	ACCA	◆ As noted above, there are many factors in force at any point in time that affect share prices. The profit or loss made by an investor does not necessarily reflect the profits or losses made by the offshore fund. ◆ The example quoted could well have worked the other way round, i.e. a resident may derive a profit by holding an investment for only a very short period of time, and the period falls within an accounting year of the

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	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: (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.		non-resident which reports an overall loss, in which case the resident would not have any deemed profits tax liability.
6.2	◆ 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	◆ Transfers in or out of units in, and periodic performance of, a fund should have been fully documented. Investment Managers [or trustees] in administering offshore funds should possess the information stipulated in Schedule 15 on the percentage of shareholding or units held by an investor at any particular point in time. ◆ As the required information should be available, it is not necessary to use a formula based on the average number of shares in issue over the year. Applying the yearly average formula may not fairly cover cases in which a resident investor holds beneficial interest in an offshore fund for

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
			less than 1 year. ◆ In fact, the proposed formula does not require daily valuations. Valuations can tie in with the dealings intervals of the fund, e.g. monthly or quarterly as the case may be.
6.3	◆ 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. There are two points of concerns, as follows: (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. (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. ◆ Recommends that provisions be introduced to the effect that the Hong Kong resident investors cannot be penalized	KPMG	◆ As noted in 6.2 above, the record of beneficial interests in a non-resident fund needs to be kept on a periodic basis in line with the dealings intervals of the fund. ◆ Under the IRO, a taxpayer would only be imposed a penalty if he fails to perform the legal obligations "without reasonable excuse". The IRD, before imposing a penalty, would consider the whole facts and circumstances in deciding whether the resident's reliance on incorrect information provided by the offshore fund constitutes a reasonable excuse in those circumstances. And a taxpayer has a right of appeal against such imposition.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	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	◆ 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 inserted into the proposed Schedule 15 to overcome the matter (please see the proposed legislative wordings in Ref. 4.3 in Appendix A).	DTT	◆ The policy is to ascertain the deemed profits by amalgamating the direct and indirect beneficial interests. The Law Draftsman will consider whether any technical amendment is necessary.
7	***Other comments***		
7.1	The Bill has not dealt with the following important issues: ◆ Tax avoidance - The Bill imposes a particular tax avoidance test on a specific class of business. But it does not exclude	Gunson	◆ The legal position is well settled. The general anti-avoidance provisions in section 61A would still apply if the relevant transaction is carried out for the sole or dominant purpose of obtaining a tax benefit and the

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	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.		conditions set out in the section are satisfied. ◆ The Bill does not specify "a particular profit source specific to a specific class of business". The Bill only allows exemption to non-resident persons in respect of securities trading profits derived from Hong Kong. The Bill does not override the well-established legal principles for determining the locality of profits. ◆ The Administration noted that Rule 5 of the Inland Revenue Rules only set out the basis of ascertaining the assessable profits of a person who carries on a business through a permanent establishment [such as a branch] in but with its head office situated outside Hong Kong. The Rule does not specify "a general test of profits tax liability for non-resident persons deriving a Hong Kong-sourced profit", and has no conflict with the Bill if a non-resident [i.e. centrally managed and controlled outside Hong Kong] has a permanent establishment in Hong Kong and carries out the qualified transactions through specified persons. The profits from such transactions attributable to the permanent establishment will be exempt from tax under the Bill.
7.2	◆ 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	HKVCA PWC	◆ Whether profits derived by private equity funds are capital in nature is a matter of fact and would depend on the circumstances of each case. If a private equity fund makes capital profit, the fund is not liable to profits tax. It is not necessary to give a special tax exemption for capital gain, which is exempt from tax under the existing

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	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.		law. ◆ Hong Kong practises a simple and low tax rate taxation system. In general, all persons carrying on business in Hong Kong are subject to profits tax. It is undesirable to give a special tax exemption to a particular type of trade. ◆ For tax certainty, a private equity fund may apply to the IRD for an advance ruling on whether its profit would be subject to profits tax provided that the relevant details are available in advance.
7.3	◆ 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	◆ A person may trade in any types of assets [e.g. landed property] through transfer of shares in private companies purposely set up for holding such assets. Inclusion of shares in private companies in effect would grant exemption to all sorts of trading transactions. ◆ Whether investments in securities issued by private companies amount to incidental transactions or "other business" depends on the ordinary course of business of the fund. It is also a question of degree according to the individual merits of the case.
7.4	◆ 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	KPMG	◆ As a matter of policy, shares in private companies are explicitly excluded from the exemption. A person may trade in any types of assets through transfer of shares in private companies purposely set up for holding such

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	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.		assets. Inclusion of shares in private companies in effect would grant exemption to all sorts of trading transactions.
7.5	◆ 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	◆ A CIS is basically a trust that invests in securities, etc. If a CIS satisfies the non-resident test proposed in the Bill, it would already benefit from the proposed tax exemption. It is therefore not necessary to amend other parts of the IRO to grant exemption again.
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	◆ The objective of the Bill is to grant tax exemption to an offshore fund by reference to its non-residency status. The authorization or otherwise by SFC does not reflect the residency status of a fund. ◆ In fact, a non-SFC authorized fund may also benefit under the Bill, if it satisfies the exemption conditions proposed in the Bill.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
			◆ Further, under s.26A(1A) of the IRO, tax exemption is already allowed to a non-SFC authorized fund that is bona fide widely held and complies with the requirements of a supervisory authority within an acceptable regulatory regime.
7.7	Suggests that a case may be made to exempt all investors from profits tax on securities traded on the Hong Kong Exchanges and Clearing Limited on the following grounds: ◆ The present stamp duty on buy and sell transactions is already a tax on the turnover. From that standpoint, it is an efficient tax in that it is collected on behalf of the IRD by stockbrokers, and provides absolute certainty. ◆ The Bill may discourage the formation of an indigenous fund management industry by tilting the playing field in favour of large international funds, and may cause the exodus of local fund management houses overseas. For example, a local investor putting the same amount of money into an international fund (where he is under the 30% threshold) and a locally managed fund (where he is over the threshold) which traded exactly the same shares and made the same profits, would be faced with very different tax consequences even though the funds may, in fact, be managed by the same local fund manager. This obviously, is not equitable. ◆ Extending the exemption to all funds would encourage the development of an indigenous fund management industry, and strengthen Hong Kong's position as a financial centre.	HKSA	◆ The objective of the Bill is to exempt offshore funds from tax in respect of trading profits derived from qualifying securities transactions carried out through specified persons. Although the exemption is not intended for onshore funds, it is conceivable that this exemption will bring in increased activities in the securities field and will thus benefit down-stream services sectors, such as the funds management sector, the legal sector, the accountancy sector and the financial services sector. ◆ The exemption is intended to boost the competitiveness of Hong Kong as a financial centre, and the scope of exemption is in line with that offered by other major financial centres, such as the United States, United Kingdom and Singapore. On the other hand, we are not aware that any major centre offers exemption to onshore funds. ◆ The proposed exemption of all securities trading profits from profits tax would not be in line with the policy intention of the Bill and would have read-across implications.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
7.8	◆ 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	◆ The deeming provisions apply to a resident investor holding beneficial interest of not less than 30% in a tax-exempt offshore fund. Moreover, if the offshore fund is an associate of the resident investor, the deeming provisions apply on whatever percentage of beneficial interest in the offshore fund held by the resident investor. ◆ The Administration sees no justification for distinguishing resident investment managers and ordinary resident investors in the application of the deeming provisions.
7.9	◆ 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	◆ See 7.8 above.
7.10	◆ Under the current tax legislation, offshore funds listed on the Hong Kong Stock Exchange are not tax-exempt as the	AIMA	◆ The objective of the Bill is to grant tax exemption to an offshore fund by reference to its non-resident status. The

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	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). ◆ 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.		listing or otherwise of an offshore fund in Hong Kong does not reflect the residency status of the fund and hence is not a factor to be taken into account in determining tax exemption. ◆ The registration of an overseas investment company as an overseas company at the Hong Kong Companies Registry would not per se affect the residency status of the overseas investment company. Such registration by itself would not change its central management and control in any way.
7.11	◆ 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	PWC	◆ See 7.9 above. ◆ The existence of the branch would not be regarded as a separate business of the offshore fund, unless the branch actually carries on some other business activities.

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
	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.		
7.12	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 CISs) 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	◆ The New Zealand IRD's publication referred to should be a government discussion document titled "Taxation of investment income - The treatment of collective investment vehicles and offshore portfolio investments in shares", which is a 75-page report. The objective of the discussion document was to review the tax rules on investment income derived by "residents" in New Zealand through different investment vehicles, including "offshore" companies established outside New Zealand. The Administration noted that the objective of the Bill is quite different, which is to allow exemption to "non-residents" in respect of offshore "funds" [i.e. money] invested in the Hong Kong local market. In the absence of more specific deputations, the Administration is unable to ascertain the relevancy of any particular information in the New Zealand publication to the Bill. ◆ Article 5 of the "Model Tax Convention on Income and on Capital" issued by the OECD is about "permanent establishment". The main use of the concept of a permanent establishment is to determine the right of a contracting state to tax the profits of an enterprise of the other contracting state for tax treaty purposes. Under Article 7, a contracting state cannot tax the profits of an enterprise of the other contracting state unless the

	Views of organizations/individuals on major issues of the Bill	Name of organization/ individual	Administration's responses
			enterprise carries on its business through a permanent establishment situated therein. ◆ Similarly, in the absence of specific deputations, the Administration is unable to ascertain the relevancy of the Article 5 and 7 to the Bill which are concerned with the definition of a permanent establishment for sharing of taxing rights and the attribution of profits to a permanent establishment for tax treaty purposes. A taxpayer with a permanent establishment in Hong Kong may be chargeable to Hong Kong tax, and if the conditions set out in the Bill are satisfied, he would then be exempt from tax in respect of profits derived from the qualifying transactions.
7.13	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	◆ The proposed CSAs will be incorporated in the Bill and IRD's clarification, interpretation and practice will be written into the DIPN.

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

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

Submission from CMTCA
(LC Paper No. CB(1)44/05-06(01))

Linklaters
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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.

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

(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),

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.

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

(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")

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)

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))

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))

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)

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

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.

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.

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

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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