KPMG Tax Limited
8th Floor, Prince's Building
10 Chater Road
Central, Hong Kong
P O Box 50
General Post Office
Hong Kong

Telephone +852 2522 6022
Fax +852 2845 2588
Internet www.kpmg.com.hk

Clerk to Bills Committee on Revenue
(Profits Tax Exemption for Offshore Funds) Bill
2005
Legislative Council Secretariat
3rd Floor Citibank Tower
3 Garden Road
Central
Hong Kong

Our ref DB/43

Contact Darren Bowdern
2826 7166

(By fax: 2869 6794 and by email:
mleung@legco.gov.hk)

12 October 2005

Dear Sir/Madam,

Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005

In response to the Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005, we have pleasure in furnishing our comments on the drafting of the Bill.

As stated in the public consultation documents leading to the introduction of the current Bill, the aim of the Bill is to put into effect the Government's announcement in the 2003/04 Budget to exempt offshore funds from profits tax. The overriding objective is to reinforce Hong Kong's status as an international financial centre by increasing its attraction to offshore fund managers and bringing Hong Kong into line with other major international financial centres, where offshore funds are generally not subject to tax. The introduction of the Bill is a welcomed initiative to provide legislative clarity and certainty with respect to the taxation of offshore funds and offshore investors.

We have made our comments from the perspective of highlighting the technical implications of the mechanics of the draft legislation as well as the practical and administrative issues that may arise from applying the draft provisions. Our comments are not intended to address the policy objective of the provisions in any way.

It is evident to us that some of the suggestions made by the industry, interested parties and the public during the consultation processes have been adopted in the Bill. Whilst we support the Government's approach as reflected in the current Bill, there are some areas of the Bill that, in our view, require further clarification and fine tuning. In this regard, we set out in the enclosed

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appendix our concerns on specific issues, areas where we believe clarification is necessary and our recommendations on certain issues.

We trust that you have found our comments helpful in facilitating further discussion on this very important Bill. If you wish to discuss any aspect of this submission in further detail, please do not hesitate to contact the undersigned on 2826 7166.

Yours faithfully
For and on behalf of KPMG Tax Limited

Darren Bowdern
Principal

Appendix 1

Exemption Provisions

Definition of resident

The term "resident" is central to the operation of the proposed Exemption Provision ("the Exemption"). Under the draft Bill, only a non-resident will be exempt from tax on profits derived from certain transactions. A 'resident' will therefore be subject to the ordinary assessing provisions of the Inland Revenue Ordinance ("IRO"), whereby they will be subject to tax to the extent that they derive Hong Kong sourced revenue profits from a business carried on in Hong Kong.

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 resident and as far as we understand it, there is no Hong Kong case law dealing with the term within the context of the Profits Tax provisions of the IRO.

As the operation of the Exemption requires the person to be a non-resident and given that the term is rarely used under the Profits Tax regime in Hong Kong, our concern is that if there is no clear interpretation of the term resident, many offshore funds that are managed from Hong Kong may not fall within the ambit of the proposed Exemption.

To ascertain whether a corporate person is a non-resident under the Exemption, the Bill looks to the place of "central management and control". However, the Bill contains no further explanation or guidance on the meaning of the term "central management and control".

To shed some light on the interpretation of central management and control, the supplementary information paper (LC Paper No. CB(1) 1425/04-05(02)) provided by the Administration further to the Legislative Council Panel on Financial Affairs meeting on 4 April 2005 contained the following comments :-

"Where the fund takes the form of a corporation, a partnership or a trust estate, its residence [or the trustee's residence in the case of a trust estate] is the place where the central management and control of the corporation, partnership or trust estate is located. <u>This normally means the place where the board of directors, partners or trustees hold meetings</u>" [emphasis added].

As central management and control is key to the definition of the term residence and therefore the potential application of the Exemption, it is crucial that this proposed legislation is enacted with a clear interpretation of central management and control either by way of legislation or Departmental Interpretation & Practice Note ("DIPN"). In our view, a clear interpretation is necessary to mitigate any potential confusion or disputes in the application of the Exemption.

The Inland Revenue Department ("IRD") has included a brief discussion on central management control in DIPN No. 32 on the Arrangement between the Mainland of China and the HKSAR for the Avoidance of Double Taxation of Income ("the Arrangement"). The brief discussion of central management and control in DIPN No. 32 related to the application of the Arrangement and in particular, for the purposes of determining a person's tax residency. However, no clear views were expressed on what constitutes central management and control in the context of determining the residency of a company.

In DIPN 32, reference was made to the frequently cited UK decision of Lord Loreburn in *De Beers Consolidated Mines Ltd v. Howe [1906] AC 455* ("*De Beers case*"). In the *De Beers* case, it was held that a company resides for the purposes of income tax where its real business is carried on and that the real business is carried on where the central management and control actually abides. At paragraph 67 of the DIPN, the IRD mentions that "this principle has been endorsed in a number of subsequent decisions of the Courts and is accepted by the Department".

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. In particular, the IRD notes that if the directors of a company are actively engaged in a particular place in Hong Kong operating a business in that place, the company will not be regarded as resident outside of Hong Kong because the directors hold meetings outside that place.

Against this background, Australian case law on the subject of residence and central management and control follows similar principles laid down in the UK decisions, except that the Australian authorities appear to draw a clearer distinction between companies with operational activities (eg. trading activities) and companies which do not carry on major operational activities but rather have, as the essence of their business, management of its investment assets. In the Australian context, this may be necessary as the Australian legislation requires a non-Australian incorporated company to carry on business as well as to have its central management and control in Australia to meet the statutory test of residency. Therefore, the factors determining where a company is carrying on business may be different to those determining where it is exercising central management and control. In our view, the Australian tax analysis of central management and control may be of more benefit to the Hong Kong tax analysis given that Hong Kong's system of taxation also incorporates a carrying on business test.

In a public taxation ruling issued by the Australian tax authorities, it pointed out that the test of central management and control looks at where the high-level decisions about the strategic management and control of a business are made. The public ruling further commented that usually these high-level decisions are made by the company's board of directors, and accordingly the place where the board meets is highly relevant in determining where central management and control is located.

The views expressed by the Australian Taxation Office in the above ruling are not dissimilar from those expressed by the IRD in DIPN No. 32. As noted above, 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 at the place where the board of directors meet to make the high-level decisions about the strategic management and control of the business.

Turning to the Bill, we are concerned that a very broad interpretation of "resident" may result in many offshore funds not qualifying for the Exemption where they are "managed" by an appointed fund manager operating from Hong Kong. We submit that a fund that is managed by Hong Kong-licensed investment advisers/fund managers should not, simply by virtue of that fact, be regarded as "resident" for the purpose of the Exemption. Accordingly, in order for the Exemption to operate effectively, we propose that residency of an entity should be based on a central management and control test that considers the location of the entity/fund's board meetings as being the influential factor in determining residency.

In previous submissions made during the consultation phase of the proposed Bill, alternatives were suggested as a means of determining the exempt status of a fund. One such alternative was to look to the residency status of investors in the fund as a basis of determining the exempt status of the fund. We understand that this basis has been followed in other jurisdictions, for example, Singapore. Very broadly, in Singapore 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 and consideration could be given to adopting such an alternative basis under the Exemption to determine whether a fund is exempt or not. The IRD's concerns of round tripping can continue to be dealt with by the Deeming Provisions.

Qualified transactions

As noted, the proposed Exemption applies only to non-resident persons in respect of profits from certain types of transactions. Under the Bill, the types of transactions qualifying for the proposed tax exemption include dealing in securities, dealing in futures contracts and leveraged foreign exchanged trading as defined in the Securities and Futures Ordinance ("SFO") through specified persons.

The inclusive list of qualified transactions follows a format that was previously adopted in another fund exemption provision of the IRO, Section 26A(1A). As an inclusive test, the principal concern we have is that it may operate to exclude many types of transactions that non-resident funds commonly undertake. For example, the list does not include trading in shares of private companies in Hong Kong and it may not include some derivative transactions entered into in connection with the fund's business.

In our view, the list of qualified transactions as presently drafted is too restrictive. In this regard, we understand that the Bills Committee also considers that the scope of the exemption should be suitably expanded to cover all the typical securities-related activities engaged by the industry.

This is certainly a welcomed development and we believe that the industry will benefit from actively participating and working closely with the Financial Services and the Treasury Bureau in ensuring the revised scope is practical and workable.

Further, the Bill requires permitted (qualifying) transactions to be executed by specified or authorised persons. In our view, it would be more appropriate for the profits tax exemption to extend 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 authorised persons under the SFO. Also, clarification is needed as to whether the exemption covers only permitted transactions executed directly by authorised persons or whether the exemption will extend to transactions executed by, for example, third party agents or brokers, upon the instructions of the authorised persons.

Transactions incidental to the carrying out of the qualified transactions

The proposed Exemption incorporates a *de minimis* test so that the exemption would not be lost as a result of 'incidental' transactions that a fund may enter into that would not otherwise fall within the ambit of qualifying transactions under the Exemption.

Under the proposal, 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.

Private equity funds

The Bill as currently drafted excludes from the proposed Exemption an important sector of the funds industry in Hong Kong, namely private equity funds. The Bill only refers to 'securities' as defined in the SFO, which specifically excludes private companies as defined under the Companies Ordinance. As discussed above, however, we are strongly of the view that such investments should not be excluded.

This apparent exclusion arises because the definition of securities referred to in the Bill specifically excludes "private companies" under the Companies Ordinance in Hong Kong. Private equity funds typically invest in unlisted or "private" companies.

In our view, 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 industry 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 more favourable jurisdictions in the region.

Deeming Provisions

Definition of associate

The “Deeming Provisions” will operate to deem an investor in the non-resident fund to be taxable on their share of the fund’s profits, regardless of whether or not such profits are realised, unrealised or distributed to the investor.

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. This would appear to be the clear intention of the drafters and is in line with other definitions of associate contained elsewhere in the IRO.

However, the definition could have potentially adverse implications to certain investors in the non-resident fund that have special shareholdings. For example, typical fund structures are established whereby the fund manager has an investment interest in the fund. Such shareholdings, sometimes referred to as “management shares”, give the fund manager certain additional rights that other investors are not entitled to. In our view, 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.

Also, the rules may have adverse implications for individual resident investors in a fund. Currently, Hong Kong residents are not subject to profits tax in respect of investment income derived from onshore or offshore funds, provided such persons are not engaged in investment activities as a trade, profession or business. However, under the proposed Deeming Provisions, Hong Kong residents directly or indirectly holding 30% or more of the beneficial interest in a tax-exempt non-resident entity would be deemed to have derived assessable profits in respect of profits earned by the non-resident fund from qualifying securities trading transactions in Hong Kong. Accordingly, the proposed exemption should incorporate rules to ensure that a resident individual is not deemed to be taxable on profits that would not otherwise fall to be taxed under the general charging provisions. That is, the Deeming Provisions should only apply to individual investors if their investment in the exempt fund would constitute a business carried on in Hong Kong. Otherwise, the proposed Deeming Provisions would essentially discriminate against individual investors in a fund as they could be deemed to be taxable on the underlying Hong Kong sourced profits, whereas a direct investment in the securities would only have given rise to a potential tax liability if the profits arose from a business carried on in Hong Kong.

Double taxation issues and other inequitable taxation results

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 unrealised profits that they have not yet derived or in fact, may never derive. For example, the profits may never be derived by the resident if the resident disposed of his interest in the non-resident prior to receiving a distribution. The proposed provisions may therefore give rise to double taxation where a resident may be assessed on the deemed profits and again upon a revenue gain on disposal of its investment in the non-resident.

This can best be illustrated by way of a simple example:

- Resident investor bought an interest in the non-resident fund for $70. The value of his investment (i.e. his proportionate share in the appreciation in value of the fund's investments) went up by $30, some of which represents unrealised Hong Kong sourced gains made by the non-resident fund. All of the $30 unrealised gain has not been distributed to the resident investor. The market value of the resident investor's investment is therefore $100 (i.e. $70 + $30).

- Under the Deeming Provisions, the resident investor is taxed on its share of the unrealised profits made by the non-resident fund, namely $30.

- Before the $30 profit has been distributed by the fund to the resident investor, resident investor disposed of the investment and realised a gain on investment of $30 (being market value of $100 less cost of $70). If the gain is revenue in nature and Hong Kong sourced, this will mean the resident investor will be taxed twice on the same gain, firstly on the attributed gain from the fund and again on the disposal of the investment.

To address this issue, we would recommend that the resident investors 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.

Another alternative would be 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.

Attribution of losses to Hong Kong resident investors

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.

Clarification is therefore needed on this aspect as it would seem inequitable if the resident investor is only attributed the profits but not losses made by the non-resident person.

Capital / revenue distinction and computation of beneficial interest

As presently drafted, the proposed rules only apply to revenue transactions carried out by the non-resident person. Questions of source and capital/revenue distinction are often difficult questions of law, which turn on the particular facts of each transaction. It is unclear under the Bill who has the obligation to make a determination as to the source and capital/revenue nature of every transaction of the non-resident person during a given year of assessment.

In terms of accuracy of information and the legal burden to provide such information, we raise two potential issues of concern:

(1) 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 and there may be practical difficulties for Hong Kong resident investors with how they can determine when they exceed the 30% threshold, especially when the resident investors are required to take account of interests held directly or indirectly by associates.

(2) 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, which involves the non-resident making source and capital/revenue nature determinations for the resident investor. It is also foreseeable that 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.

    To alleviate the potential cumbersome burden imposed on the Hong Kong resident investors, we recommend that provisions be introduced to the effect that the resident investors cannot be penalised for relying on information provided by the fund manager, if the information is subsequently found to be incorrect.

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