

香港稅務學會

THE TAXATION INSTITUTE OF HONG KONG

(Incorporated in Hong Kong as a company limited by guarantee)



3 September 2005

BY HAND AND BY FAX (2530 5921)

Clerk to Bills Committee
Legislative Council Secretariat
3rd Floor Citibank Tower
3 Garden Road
Central
Hong Kong

Dear Sir/Madam,

REVENUE (PROFITS TAX EXEMPTION FOR OFFSHORE FUNDS) BILL 2005 ("BILL")

We write in response to the Bill and your letter dated 21 July 2005. The Taxation Institute of Hong Kong has made submissions on the First and Second Consultation Papers on the same topic published by the Financial Services and the Treasury Bureau (the "FSTB") before.

Since the Bill has largely followed the approach adopted by the Second Consultation Paper, some of the points we made in our submission to the Second Consultation Paper have been reiterated and repeated.

In order for our discussion to be more focused, we have throughout this letter use the term offshore funds instead of the term non-resident person (which includes an individual, a partnership, a trustee or a corporation). Our comments though equally apply to offshore entities which are not necessarily fund vehicles.

Terms and words used in this letter, unless otherwise defined, should be accorded the meanings as those terms and words are defined in the Bill.

1. **Introduction**

The Bill proposes to exempt "qualifying" profits of "qualifying" offshore funds from profits tax (the "**Exemption Provisions**"). In order to combat tax leakage through round-tripping, the government has also included the Deeming Provisions by making certain types of investors resident in Hong Kong who invest in those offshore funds subject to profits tax on a deemed basis.

2. **Policy Consideration**

If the Bill's main purpose is to exempt offshore funds from profits tax, we believe, subject to our comments below, the Bill has achieved its purpose. However if the Administration's intention to introduce the Bill were to encourage the growth of funds management industry in Hong Kong, then the Bill has failed its purpose.

As we believe that most policy issues should have been carefully considered by the Administration and lobbied by various interest groups, our comments in this letter will only be confined to technical matters arising from the Bill.

3. **Exemption Provisions (section 20AC)**

The Exemption Provisions grant exemption from profits tax to those offshore funds without regard to the composition of their beneficial owners. Profits qualified for exemption are profits derived from Hong Kong from securities trading transactions carried out through certain qualified persons and offshore fund must not otherwise carry on any other business in Hong Kong.

4. **Distinction between resident and non-resident funds**

The concept of residence does not sit well with the territorial concept of taxation, and we think, to the extent possible, we should minimise invoking this concept in the Bill.

Determining the residence of a person is fraught with practical difficulties and uncertainties as it depends on the particular fact of each case and relative weight has to be put in evaluating each factor.

We believe that if an onshore / offshore distinction has to be made nonetheless, in order to qualify for exemption, a fund must be able to satisfy a more straight-forward and objective test which should be consistently applied. In fact we suggest that only pertinent factors like the place of incorporation (if the fund is a corporate vehicle) and the place where the management decision is made should be looked at in order to determine the residence of offshore funds.

We believe the IRD should issue a practice note to spell out how the "central management and control" test should be applied. In addition, like some overseas revenue authorities, the IRD should consider issuing a standard questionnaire for determining residence of offshore funds. The usage of a standard questionnaire would help to create consistency in the application of a otherwise highly discretionary test.

5. **Deeming Provisions (section 20AE)**

The Deeming Provisions consist of two legs which will be invoked when:

- A resident person, alone or with his associates whether resident or non-resident, directly or indirectly holds 30% of the issued share capital in a tax-exempt offshore fund; or

- A resident person directly or indirectly holds any percentage of the beneficial interest in a tax-exempt offshore fund which is his associate.

6. Threshold with triggers the Deeming Provisions

Conceptually we find it difficult to justify the use of a 30% threshold. Although the Administration may take the view that an investor with a 30% interest in an offshore fund may have the necessary leverage to request the trustee or the manager of the offshore fund to provide the investor with detailed information required for completing his tax return, in practice, it is often not the case (especially when this 30% threshold also includes the holdings of associates). From a practical perspective, we believe it will be more equitable if the triggering threshold could be raised to 50%.

In respect of offshore funds which have issued various types of shares with different participation and voting rights, investors will need further guidance on how the triggering threshold should be calculated.

7. The rationale of bringing individuals into the Deeming Provisions

In theory 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. The dichotomy is that, from a point of evidence (of proving that the individual is carrying on a trade) and enforcement, we believe that the number of individuals caught by the profits tax regime as a result of trading in Hong Kong securities is extremely low. If such is the case, we would request the government, as an administrative expediency, to carve out individual investors from the Deeming Provision as we believe the "tax leakage" resulting from such carve out should be extremely low and it is also not logical to request resident individual investors to be subject to the Deeming Provisions while if he is otherwise trading directly in Hong Kong securities onshore he would in practice not be subject to profits tax.

8. Definitions of Associates

We do not think a convoluted and broad definition of the term "associate" will help compliance. This term should be very narrowly and tightly defined in order to help resident investors, especially international groups with a large number of group companies, to provide the necessary information to the Inland Revenue.

9. Incidence of Double Taxation

There is a concern that a resident investor could theoretically be double taxed. The resident investor may be exposed to tax in respect of the securities trading income of an exempted offshore fund under the Deeming Provisions as well as tax on his eventual disposition of the interest in such exempted fund.

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Therefore, the Deeming Provisions should be amended in a way that would remove this possibility of double taxation.

Yours sincerely,



Kenneth Leung
Vice-Chairman
Taxation Review Committee