



AIMA Hong Kong Chapter

Alternative Investment Management Association (AIMA)

The Forum for Hedge Funds, Managed Futures and Managed Currencies

By Fax to the Clerk to the Bills Committee (Fax: 2869-6794) and Email (mleung@legco.gov.hk)

13th October, 2005

Hon. James Tien Pei-chun, GBS, JP
Chairman of the Bills Committee
Legislative Council
Legislative Council Building
8 Jackson Road
Central
Hong Kong SAR
The People's Republic of China

Dear Sirs,

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

We refer to the Invitation for Submissions dated 22 July 2005 issued by the Hon. James Tien Pei-chun, Chairman of the Bills Committee with respect to the Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005 (the "Bill"). The Bill seeks to amend the Inland Revenue Ordinance (Cap. 112) (the "IRO") to give legal effect to the proposal of providing profits tax exemption for offshore funds.

As an association representing the alternative investment industry such as hedge funds, managed futures funds and managed currency funds, we, the Alternative Investment Management Industry Association, Hong Kong Chapter ("AIMA") welcome the Administration's intention to promote the investment fund industry. We are supportive to the Administration and share the view that the proposed legislation will bring positive results to the economy of Hong Kong. However, it would appear that there may be a misunderstanding on the part of the Inland Revenue Department ("IRD"), in that they seem to be using the term offshore "funds" in the sense of offshore "money" rather than in the sense of collective investment schemes.

Importance of the Alternative Investment Management Industry to Hong Kong

AIMA welcome the Bill as it seeks to exempt offshore funds from Hong Kong taxation. These latest developments culminating in the Bill are a reflection of the Administration's commitment to position Hong Kong as an international financial centre, a regional hub for Asian fund management and the capital market for the Mainland.

The alternative fund management industry is becoming an ever greater contributor to Hong Kong's economy. The Hong Kong alternative fund management industry has experienced significant growth over the last five years, both in terms of the number of funds being managed and the value of assets under management ("AUM"). The number of alternative funds under management grew from 22 in the year 2000 to 81 by the end of 2004 and this number is expected to reach 113 in 2005. The value of AUM stood at HK\$3,821 billion in the year 2000, was almost HK\$9,014 billion at the end of 2004 and is expected to top HK\$11,202 billion in 2005. These figures represent an annualised growth rate of

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38.62% in the number of alternative funds and 24% in the AUM since the year 2000. Please refer to Appendix 1 for details.

In order to be licensed by the SFC to manage money in Hong Kong, the manager must demonstrate that it has adequate human, financial and other resources. Accordingly, the industry provides direct benefits to the economy, for example by generating employment, contributing to both the office and residential property markets, and indirect benefits through the various service industries which are dependent upon it, such as fund administrators, prime brokers, lawyers and accountants.

Clearly therefore the alternative fund management industry is worth a significant amount of money to Hong Kong and the Government can ensure that that its rate of growth is maintained and even increased going forward. This will not be easy in the face of stiff competition from other Asian jurisdictions but we believe the Bill demonstrates the Administration's desire to move in the right direction.

It cannot be good for the fund management industry in Hong Kong if there is a perception (even if misguided) that funds managed by Hong Kong residents may be liable to tax here. The industry is quite delicate: it requires the right conditions to grow, and the tax climate plays an important part. The UK is suffering an exodus to the Channel Islands over similar concerns. The growth of the industry in Hong Kong has been sustained over recent years in the face of concerns over the potential tax issue because the industry has taken comfort in the very strong assurances that have been given by senior members of the Administration that the issue would be addressed. It is important that those assurances are now carried into effect.

Common features of an investment fund structure

Before we proceed to list out the issues AIMA's members have brought up, it may be useful to provide at this point the relevant features of a typical offshore fund structure:-

In a typical offshore fund structure, the investment fund management or advisor company ("Investment Manager") is usually a Hong Kong incorporated company while the fund is established outside of Hong Kong. The Investment Manager or its overseas associate or parent company typically holds the management shares of the offshore fund for operational reasons (e.g. so that it can appoint directors to the board of the offshore fund and to enable the fund to undertake certain corporate actions during the time when there are no participating investors in the offshore fund). Generally, these management shares are non-participating in any profit distribution thus giving legal but not economic control to the Investment Manager.

Some offshore funds are structured in such a way that there will be a separate offshore management company to which the onshore Hong Kong investment advisory company will provide advice in relation to the fund's investments. In this scenario it is usually the offshore management company that holds the management shares.

Few investors will invest in a fund without an established track record of at least 2 years. It is therefore common practice for the Investment Manager and /or its associates to start up a fund by investing their

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own seed capital. The seed capital could result in the offshore fund being controlled by the Investment Manager in the early years of its existence.

Investors are unlikely to be willing to invest in a fund if there is a risk that they will suffer tax indirectly on the fund's underlying investments (because the fund itself may be liable to tax) and again directly because he may be liable to tax on profits derived from the holding or disposal of his investment in the fund.

Similarly, an investor must not be put in a position where it is less tax efficient for him to invest in a fund than if he were to hold the underlying investments in a segregated account.

The fact that most funds managed in Hong Kong are established outside Hong Kong stems from two primary issues:

1. It is not possible to establish an open-ended investment company under Hong Kong law due to constraints on reductions of capital by Hong Kong companies;
2. Prior to 1997, there were concerns in the investment community regarding the stability of Hong Kong following the Handover.

It is our belief and hope that legislation could be introduced to facilitate the incorporation of open-ended investment companies in Hong Kong. There are many models to choose from, and no good reason why we should pay millions of dollars a year to the Cayman Islands, the British Virgin Islands and other such overseas jurisdictions just because of an antiquated technical anomaly of Hong Kong law. The sovereignty concern is no longer an issue.

Accordingly, we would urge that legislation 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 collective investment scheme as defined in the Securities and Futures Ordinance, whether established in Hong Kong or elsewhere, rather than limiting the exemption to "offshore" funds.

The following are the issues noted during the discussions we have had with our members.

I. Section 20AB(2) Definition of "Non-resident person"

The Bill defines residence of a corporation, partnership or a trustee of a trust estate as the place where its central management and control is exercised. The term "central management and control" is not defined in the IRO or the Bill. The Inland Revenue Department ("IRD") in paragraph 5 of the Supplementary Notes / Responses to Industry's Concerns ("Supplementary Notes") issued on 4 October 2005 by the Financial Services and the Treasury Bureau states "the central management and control of a company refers to the highest level of control of the business of that company". We fully support this view. Given the Supplementary Notes are not part of the Bill, we sincerely hope that a Committee Stage Amendment ("CSA") be introduced to the Bill to give legal binding effect of the above view. We submit such an amendment will ensure the consistent interpretation and application of

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the “central management and control” in the future. Furthermore, we welcome the examples given in Annex A to the Supplementary Notes. The examples give some clarifications and guidance on what makes a person to become a “resident” or a “non-resident”. 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.

II. Section 20AC(2)(a) Scope of exemption

We are pleased to note that the Administration will move a CSA to introduce two new schedules to the IRO to expand the scope of qualified transactions and to expand the meaning of “securities” in the context of the Bill if necessary (paragraph 12 of the Supplementary Notes refers). We also noted in paragraph 13 of the Supplementary Notes that the Administration is prepared to move a CSA to expand the scope of specified persons. The amendments will improve the effectiveness of the Bill significantly and further strengthen Hong Kong as one of the leading asset management centres.

III. Management shares

We applaud the Administration’s agreement to move a CSA to carve out management shares from the application of the Deeming Provisions (paragraph 23 of the Supplementary Notes refers).

IV. Section 70AB Retroactive application of the Bill

It is encouraging to find that the Bill will have retrospective effect from 1 April 1996. We welcome this provision.

V. Schedule 15 Provisions for ascertaining amount of assessable profits of resident person under Section 20AE

The formula imposes unreasonably onerous obligations in terms of keeping information on units held in funds. It requires the Investment Managers to keep a record of the number of units held in a fund on each day in the period. Most unregulated funds provide for monthly or quarterly dealings and so only prepare monthly or quarterly as opposed to daily valuations. We suggest that the formula should be based on the average number of shares in issue over the year.

VI. Section 20AE Assessable profits of non-resident persons regarded as assessable profits of resident persons (the “Deeming Provision”)

We agree that it is necessary to have effective Deeming Provisions in the legislation to prevent any person from abusing the exemption system. However, the scope of the Deeming Provisions under the Bill is too wide and may discourage managers of genuine funds domiciled overseas coming to Hong Kong. We believe this is not the intention of the Administration. 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. The Administration considered that administering the Deeming Provisions by reference to the source of funds is impractical and open to abuse (paragraphs 31 to 33 of

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the Supplementary Notes refer). We do have reservations on this explanation. We suggest that 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. Relief from the Deeming Provision 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.

VII. Hong Kong listed offshore funds

Currently, the Hong Kong Stock Exchange is not listed as a supervisory authority within an acceptable regulatory regime under Section 26A(1A)(ii) of the IRO which specifically exempts offshore funds from being taxed in Hong Kong, if the offshore funds are bona fide widely held. Therefore under the current tax legislation, offshore funds listed on the Hong Kong Stock Exchange are not tax-exempt. 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 (Section 20AC(5)). We understand that overseas investment companies listed in Hong Kong need to register as overseas companies at the Hong Kong Companies Registry. Will this registration constitute carrying on business in Hong Kong by such funds? If so, the proposed tax exemption will not be applicable to them. We suggest that rather than penalizing these funds, the Administration should encourage more overseas funds to be listed in Hong Kong. The Exemption Provisions should be amended to also exempt offshore funds listed in Hong Kong.

We believe that exempting overseas funds from Hong Kong profits tax will attract more overseas funds coming to Hong Kong and improve the competitiveness of Hong Kong. We support the enactment of the Bill into law. However, the Bill still has room for improvement. We sincerely hope that the honourable members of the Legislative Council will take our comments and suggestions into consideration before passing the Bill.

We trust you will find the above useful. Should you wish to discuss further with us any of the above comments, please contact the undersigned by telephone on 852-2822-5536 or by email at christophe.lee@shkco.com.

Yours truly,

On behalf of the Alternative Investment Management Association Ltd.

Christophe Lee

Chairman, AIMA Hong Kong Chapter

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Appendix 1 – Significant Growth of the Hong Kong Alternative Investment Management Industry

Year	AUM (HK\$ billion)	YOY GROWTH RATE	Year	No. of Funds	YOY GROWTH RATE
2000	3821.68		2000	22	
2001	5201.68	36.11%	2001	33	50.00%
2002	6745.68	29.68%	2002	50	51.52%
2003	8063.68	19.54%	2003	62	24.00%
2004	9013.68	11.78%	2004	81	30.65%
2005(E)	11202.202	24.28%	2005(E)	113	39.04%

E=EXPECTED

Annualised Asset growth since 2000

24.00%

Annualised Funds growth since 2000

38.62%

Source: EurekaHedge

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