LC Paper No. CB(1)44/05-06(13)
(English version only)

19 October 2005

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

Dear Sirs,

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

You have requested the Hong Kong General Chamber of Commerce ("the HKGCC") lodge a written submission on the Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005 ("the Bill").

Enclosed for your information is a copy of the submission that the HKGCC made to the Government in February 2005 in relation to the Consultation Paper that preceded the Bill.

Consistent with that early submission, the HKGCC fully supports the introduction of an exemption from Hong Kong Profits Tax for offshore funds.

However, the HKGCC has strong reservations about the introduction of the Deeming Provisions proposed in the Bill.

The primary concerns of the HKGCC are as follows:

1) **The Deeming Provisions represent a shift from the existing "source-based" taxation system to one of determining tax liability on the basis of residence**

   Hong Kong has a long and proud history of taxation based on, that is, what is done in Hong Kong may be taxable; what is done outside Hong Kong cannot be taxed. The residence of the taxpayer was simply not relevant. The Deeming Provisions in the Bill seek to change that fundamental concept, albeit in a subtle and unheralded way.

   While we understand the anti-tax avoidance justifications for the Deeming Provisions, we do not believe that the only, or even the best way to achieve the desired results is by laying down a precedent of determining tax liability by virtue of the taxpayer's residency.

   We have grave concerns that the Deeming Provisions in the Bill, despite assurances to the contrary, may prove to be the thin end of the wedge in opening Hong Kong to other than territorial tax liability.

2) **The Deeming Provisions represent an unjustified complication to the Inland Revenue Ordinance (“the Ordinance”).**

Hong Kong has also long prided itself on having a fair and simple tax system. The Deeming Provisions deem for taxation purposes a Hong Kong resident to have derived notional income equivalent to the actual income that has been earned and accounted for by a non-Hong Kong resident. This is a fundamental move away from simplicity and towards un-necessary complexity.

This is particularly the case when the Administration arguably has the anti-avoidance rules in Sections 61 and 61A of the Ordinance at its disposal to deal with the particular mischief with which the Deeming Provisions are being justified.

The Administration is concerned with the potential abuse of the Exemption Provisions by Hong Kong taxpayers who would otherwise be trading in Hong Kong securities. This abuse could conceivably arise where such taxpayers “round trip” by setting up investment funds offshore and conducting otherwise taxable trading through those funds. There is little argument that such activities should be taxed in Hong Kong.

However, 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 center, i.e., potential collateral damage to transactions not targeted by the Administration. 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 Provisions. This complexity could arise completely unbeknownst to the Hong Kong company and in purely commercial circumstances far removed from the avoidance scenario contemplated by the Administration.

3) **The Deeming Provisions will create a new and otherwise unnecessary information gathering burden on Hong Kong based groups who have overseas subsidiaries.**

The Administration has not adequately considered and addressed the business communities’ concerns about meeting the reporting requirements under the Deeming Provisions (para 32 of the Supplementary Notes).

Hong Kong corporate groups with operations overseas will be required to implement new information gathering processes to ensure compliances. The issue is not whether such information is available but rather whether every Hong Kong taxpayer with overseas subsidiaries will be required to positively determine that each such subsidiary has not made investments subject to the Deeming Provisions. This compliance burden has been discounted by the Administration but will represent a real cost to Hong Kong taxpayers.

If, contrary to our view, it is resolved that the Deeming Provisions are the only way of countering the inappropriate exploitation of the exemption provisions with which the Administration is so concerned, a number of fundamental issues would need to be addressed in the drafting of the Bill.

These include:

1) **Defining "Residence"**

A clear definition of what constitutes residence must be in the law itself and not in a Departmental Interpretation and Practice Note (DPIPN) or Supplementary Notes to the Bill. The Administration's current view as set out in the Supplementary Notes is 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.

This must be legislated so that taxpayers have this certainty and are not faced with a judicial body (or, indeed, the Administration itself) taking a different view at some stage in the future after tax returns have been lodged.

2) **Double Taxation**

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 (see para 24 of the Supplementary Notes).

With due respect, 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 (see para 25 of the Supplementary Notes), and (ii) taxes paid by the same person twice (see para 26 of the Supplementary Notes). Moreover, this double taxation could be aggravated in situations where the nonresident person is also subject to tax imposed by another country.

For example, if a United States subsidiary of a Hong Kong company invests in an Offshore Fund in circumstances where the Deeming Provisions apply, both the US company and the Hong Kong company will be taxed on the same income. The US cannot give a credit for the tax imposed by Hong Kong as the tax is not imposed on the US company but rather through the Deeming Provision on the underlying Hong Kong investor. It is also interesting to note that it would not appear the HK resident would have had much of any tax avoidance motive under this scenario given the US tax rate is significantly higher than that of Hong Kong.

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.

For the reasons outlined above, the HKGCC urges the Bills Committee to either reject the Deeming Provision in the Bill or amend the Bill to address the concerns expressed above.

Yours sincerely,

Dino Farronato
Chairman
HKGCC – Tax Committee

7 February 2005

Principal Assistant Secretary for the Treasury (Revenue)
Treasury Branch, Financial Services and the Treasury Bureau
4th Floor
Central Government Offices, Main Wing
Lower Albert Road
Hong Kong

Dear Sir,

We refer to the Consultation Paper on Exemption of Offshore Funds from Profits Tax ("the Paper") and your request for submissions.

1. Background

The Paper sets out a proposed revised approach to exempting offshore funds from Hong Kong Profits Tax where the offshore funds derive income from securities trading transactions undertaken in Hong Kong through a broker or approved investment adviser.

We agree with the conclusions reached on the "Former Approach" (as set out in the January 2004 Consultation Paper) that local brokers should not be burdened with an obligation to determine the residential status of beneficial owners of funds for whom they are acting.

We have no comments on the "Exemption Provisions" as set out in the Consultation Paper but do wish to highlight some serious concerns on the "Deeming Provisions".

2. Proposal

We do not agree with the "Revised Approach" recommended in the Consultation Paper of putting an obligation on a "resident beneficial owner" to report deemed assessable profits from securities trading transactions conducted on behalf of a non-resident where the resident owns 30% or more of that non-resident. The proposed Deeming Provisions are in essence a form of foreign controlled company rules akin to the Sub-Part F rules applying in the US. As such, the proposed "Deeming Provisions" would introduce a complexity to the Hong Kong tax system totally out of proportion to the objective they are aiming to achieve. In particular:

a) resident beneficial owners would need to identify all securities trading transactions from companies in which they have minority interests (as low as 30%). In many cases this will not be practically possible due to difficulties in obtaining such specific information in a timely manner;

b) the inclusion of interests held by non-resident associates means that, for example, a Hong Kong subsidiary of a multinational would need to identify all securities trading transactions in sister companies in which they also hold any beneficial interest. Again in many cases this will not be practically possible;

c) the proposed rules do not take into account the fact that the profits from securities trading may well be taxed in the country where the non-resident is located which would lead to double taxation.

d) the proposed rules assume that it is a simple matter to differentiate between trading activity (to which the deeming provisions will apply) and capital gain (to which the deeming provision will not apply).

For these reasons, we strongly recommend that the proposed Deeming Provisions not be adopted.

If the Government insists that some from of deeming provision must be introduced it should only apply where:

a) the resident investor has control over the non-resident (i.e. greater than 50%); and
b) the profits are not taxed in the country where the non-resident is located.

3. The Consultation Process

As a final point we wish to comment in the consultation process. We commend the Government's efforts to seek input on such legislative changes prior to their introduction.
However, releasing such a paper on 31 December 2004 and requiring responses to be lodged within six weeks does not give sufficient time for important issues to be fully considered. The timing of requests for consultation should be mindful of periods of extended leave such as early January and Chinese New Year if the process is truly to be regarded as one of consultation.

We trust these comments are of assistance to you.

Yours sincerely

Eden Woon
CEO