

Clerk to Bills Committee
Legislative Council
Legislative Council Building
8 Jackson Road
Central
Hong Kong

For the attention of Ms Debbie Yau

7 October 2005

Dear Madam

Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005 (“the Bill”)

We refer to your letter of 21 July 2005 inviting us for comments on the above Bill, and the Supplementary Notes received on 4 October which address and clarify certain issues in the Bill. On behalf of ACCA (Association of Chartered Certified Accountants) Hong Kong, we are writing to submit our comments as below.

Section 20AB(2)

This sub-section defines a “resident” person for the purposes of both the exemption provision, section 20AC and the deeming provision, section 20AE.

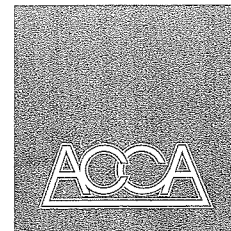
We note that the objective of the proposed new legislation is to exempt offshore funds from Hong Kong Profits Tax in order to reinforce the status of Hong Kong as an international financial centre. It therefore should not be the Government’s goal to widen the tax net to catch resident individual investors who should not be subject to Profits Tax on their investment income. We agree that “the presumption that an individual is unlikely to carry on a share dealing business is not law but rebuttable facts”, as mentioned in paragraph 37 of the Supplementary Notes. We therefore consider that including a natural person under the deeming provision has an undesirable effect as the individual would by operation of this new provision be chargeable on the “deemed assessable profits from a trade, profession or business carried on in Hong Kong”, without reference to his or her genuine intention which are rebuttable facts.

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However, we consider that for the interpretation of section 20AC which is the exemption provision, non-resident individual investors can be provided with tax certainty for their returns on these offshore funds investing in Hong Kong.

As such, we suggest that the definition of "resident" for "natural person" should only be included for the interpretation of section 20AC.

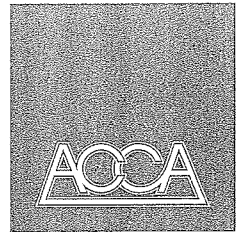
Section 20AB(2)(a)(ii)

Under the definition in this sub-section, 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 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. That said, we note that there is no particular enforcement provision for the collection of tax from this deemed resident investor, which makes the provision practically difficult to enforce.

With reference to paragraph 10 of the Supplementary Notes, however, the residence 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 the fund changes its residence status during a year of assessment. Given the similar rationale, we consider that section 20AB(2)(a)(ii) is disadvantageous to individual investors as, as illustrated in example (a) above, such investor would be by definition of "resident" not be allowed split year residence.



Section 20AB(2)(b)

According to the Bill, the traditional concept of “central management and control” of the corporation is adopted in determining the residence of a corporation. We are concerned that in any event 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. However, we are pleased to note from the Supplementary Notes that the Inland Revenue Department will incorporate examples in a Departmental Interpretation and Practice Note to clarify issues in determining the “location of central management and control”.

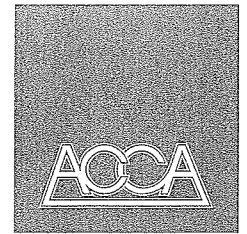
Section 20AC(5)

We note from example 10 in Annex A to the Supplementary Notes that 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. We suggest that the sub section should however be expanded with a condition where the prescribed activities are financed by funds of that trade, profession or business in Hong Kong, although we note the Administration’s position on the source of fund. We believe that the rationale of the Bill is to encourage inflow of foreign funds and as such, an escape clause available for the investment with a genuine non-Hong Kong fund is consistent with this underlying rationale.

In making this suggestion of escape clause, we are mindful of the situation that if the Hong Kong operation in the said example 10 was carried on by a Hong Kong subsidiary (instead of a Hong Kong branch) of the Japanese company, exemption would be allowed to the offshore fund invested by the Japanese company. We feel strongly that the investor (the Japanese company in this example) should not be disadvantaged because its other arm of business in Hong Kong is conducted through a branch instead of a subsidiary.

Section 20AC(6)

We consider that where a transaction is incidental to the transactions referred to under sub-sections (2) to (4), it should be part and partial of these activities. As such, the incidental transaction should also be an exempt transaction with the prescribed activities. Accordingly, there is no requirement to set the 5% ceiling or to deal with, if a ceiling is set, the definition of “total trading receipts” which could be difficult for some trading instruments or transactions. An example is that it is unclear whether the notional principle or the gain / loss on settlement for a foreign exchange contract should represent the “total trading receipt”.



We therefore suggest that this sub-section be removed from the proposed section 20AC.

Section 20AE(2)(a), (b) and (c)

We reiterate our previous recommendation, under cover of our letter dated 31 January 2005 responding to the Consultation Paper on Exemption of Offshore Funds from Profits Tax, that the threshold be uplifted to 50% so that subsection (1) will only apply to situation if the resident, on his own or together with associates, has control over the non-resident investment.

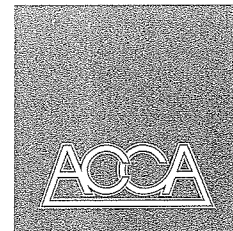
Although we appreciate the rationale of the legislation to identify possible round-tripping transactions carried out by a resident, we consider that where the resident investor only holds an insignificant interest in an offshore fund, it may not be appropriate to treat the investor as having control over the activities of the fund, in particular where the interest is held by the resident's overseas associate.

Schedule 15

We understand that the formula provided under Schedule 15, with the example set out in Annex B to the Supplementary Notes, can facilitate easy administration in ascertaining the assessable profits of the resident person. However, the formula assumes that profits are derived evenly on a daily basis over the accounting year. It has ignored 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. In this respect, we consider that 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 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. We therefore suggest that 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. We also suggest that where the resident derives a loss from the holding of the investment, no assessable profits should be calculated accordingly.

Escape Clause

We note that the current draft legislation does not provide an escape clause for dispensing with the application of the deeming provision. Some flexibility should be allowed for a resident to escape from the deeming provision if he can justify that no round-tripping is involved. For example, 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 strategy of the overseas subsidiary) should be provided with an escape clause from the deeming provision.

Should you like to clarify any of our above comments, please do not hesitate to contact Ms Sonia Khao, Head of Technical Services (Hong Kong) or myself at 2524 4988.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Jimmy Chung', is positioned above the printed name.

Jimmy Chung
President