The British
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in Hong Kong

香港英商會

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Our Ref.:

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Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005

We are writing to advise you of the Chamber's views on this proposed Bill and the two sets of supplementary notes ("notes") on the Bill, which were circulated to some parties subsequently by way of further explanation of some of the terms and proposed operation of the Bill.

The Chamber had earlier this year written in response to previous FSTB consultations on the exemption of offshore funds from Profits Tax. While some of the points contained in our submission (a copy is attached) have been dealt with, others remain outstanding and are still of great concern.

In particular, we are concerned that, despite the changes made to the proposals since they first emerged in early 2004, the current proposals, as contained in the Bill, would tend to discourage a large number of new, or existing, boutique fund managers from operating in Hong Kong, for the reasons set out below. This legislation may not therefore be seen as a move to improve Hong Kong's status as an international financial centre and its attraction as a base for a range of different funds catering primarily to offshore investors.

We are particularly concerned that the Inland Revenue Department ("IRD") may issue back Profits Tax Assessments on funds which did not comply with the new laws, and where the IRD have detailed information on hand about those funds but have not so far raised assessments whilst this legislation is being discussed. If the IRD raise substantial numbers of such back Profits Tax assessments the perception of the tax system here being fair and certain will be damaged; especially in the eyes of offshore investors. These funds, which will mostly be boutique funds have not accrued for such Profits Tax charges in their accounts, and could not have known that the laws would be drafted and implemented this way nearly ten years later on. So, we think there should be no retrospective action on this legislation and if enacted it should be implemented with effect from 1st April 2006, not 1st April 1996 as currently proposed.

Going forward, the Chamber believes that if the legislation is to be implemented the exemption from Profits Tax should apply based on the location of the investors in the fund but without imposing overly complicated administrative arrangements or "look through" tests, which formed part of the first set of proposals.

There are disadvantages of defining the residence of the fund in terms of the Central Management and Control and applying the deeming provisions, in our view, which potentially outweigh the benefits of the proposed exemption.

Central Management and Control ("CMC")

Introducing a CMC test into Hong Kong tax legislation for determining the residency of a corporation, partnership or trustee of a trust estate by reference to this concept adds complexity and uncertainty to the territorial taxation system in Hong Kong, and will in practice result in the need for complicated fact-finding.

Examples 7 and 8 in the supplementary notes epitomises the problems with the proposals; as these would typically be boutique funds. In example 7 the investment vehicle Company G would be subject to tax even though all the investors are non-resident, and therefore they would not normally be subject to tax in Hong Kong. Purely because the CMC of the fund is in Hong Kong, and under the current proposals that is all that is required to make the fund itself subject to Profits Tax. Example 8 was later produced to amplify the point that if the CMC of the fund was not in Hong Kong the fund would be outside the scope of Profits Tax. If in fact the Administration is encouraging boutique funds to "fit in " with the new legislation by appointing overseas resident Directors and having Directors" board meetings (and presumably shareholders meetings) outside Hong Kong this seems to be defeating the purpose of encouraging such funds to set up in Hong Kong at all.

In boutique funds, of which there are many in Hong Kong and they are vital to smooth functioning of the capital markets here, the role of the fund managers is essentially that of day-to-day management of the fund. In our view, this is a classic case of the type of fund that should be able to benefit from the exemption. Insofar as the Financial Secretary was responding to calls from the business sector for an exemption for certain types of non-SFC-authorised offshore funds to be granted an exemption, in part to address the uncertainty that they faced and continue to face, example 7 represents the kind of arrangement that should be exempted.

So the legislation as drafted, relying on a CMC test , will either invite funds to create an unnecessary arrangement to circumvent the limitations in the example 7 situation, which will itself, ultimately, lead to unwelcome debate and uncertainty (e.g., over whether a particular set-up is artificial or has substance), or it will simply discourage funds from employing Hong Kong-based funds managers in the first place, or relocating fund managers to Hong Kong, which, in our view, defeats the purpose.

We believe that in terms of the definitions of CMC, if implemented, that international norms should be adopted. UK tax case law in the CMC area, and UK Inland Revenue Statement of Practice (SP1/90), and the Australian case law and Taxation Rulings (ATO - Taxation Ruling 2004/15) should be the reference points - since they are essentially the same tests, although they do look at "substance over form".

We note that in terms of defining "residence" of an individual investor that the Hong Kong Personal Assessment definition is to be used although this is not based on an internationally accepted practice, being peculiar to Hong Kong. In due course it may conflict with residence as defined in many Double Taxation Treaties which Hong Kong is currently negotiating.

Split year residence

The concept of "split year residence", as referred to in paragraph 9 of the notes is not a concept familiar to the Hong Kong taxation system. Clarification of how this would work in practice should be given, if the legislation is implemented. For example, if a fund becomes "resident" in Hong Kong during the year would it be taxable on only profits made during the period of its residence?

Scope of exemption

The potential for abuse by injecting immovable properties into a private company (as described in the footnote on p.4 of the notes) should not, on its own, exclude all shares in private companies from the scope of the term "securities". In our view it would be preferable, if the legislation is enacted, to include shares in private companies within the scope of the term, except perhaps for those companies, which predominantly hold immovable property.

Double taxation resulting from the deeming provisions

We do not agree with all the analysis contained in paragraphs 22-25 of the notes. As a result of the deeming provisions, the resident person may have to pay tax in place of the offshore fund and may also be liable to tax when he or she sells the shares in the fund. This amounts to double taxation. More importantly, with reference to the example in paragraph 23 of the notes, where a resident investor pays tax on the gain on the disposal of shares in a listed company, the sale price of the shares would reflect the Profits Tax paid by the company. However, because a resident investor is liable to tax on the undistributed profits of an offshore fund, where that investor disposes of his shares in the fund and realises a gain on the disposal, double taxation would apply (where the gain on the disposal of the units in fund is regarded as Hong Kong-sourced revenue profit), because the price of the shares will not reflect any tax paid.

No deemed loss available for set off by a resident investor

Nor do we agree with the analysis contained in paragraphs 26-27 of the notes as a justification for denying a resident investor a deemed loss to set off against other taxable profits, where an offshore fund makes a loss over the year.

If an offshore fund is not exempt, then it should be treated in the same way as any other Hong Kong company and, thus, there would be no reason to deny it loss relief. As regards the application of general anti-avoidance provisions, under section 61A, in the normal course of events, any artificial transactions are ignored and, if the taxpayer then becomes taxable, he or she is entitled to offset any losses that may arise.

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We trust that you find our comments above helpful. If you would like to arrange a meeting on these matters prior to the Legco Bills Committee meeting please let us know. Our representative at the Bills Committee will be making these points.

In this case bad law (i.e. which encourages many to circumvent it) may be worse than no law. Even though the administration is obviously keen to rush this legislation through, in our view it should not be too hasty, owing to the importance of this industry to the healthy functioning of Hong Kong's capital markets.

Yours sincerely,

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