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. We have responded to the First and Second Consultation Papers on the profits tax exemption proposals for offshore funds 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 response to the Second Consultation Paper have been reiterated.

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 may include 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 were to encourage the growth of funds management industry in Hong Kong, then the Bill has failed its purpose.

Our comments in this letter will only be confined to the salient issues 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 the 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 in Hong Kong - to the extent possible, the Administration 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 quite often each factor has to be subjectively weighted.

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 is 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 a fund.

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 an otherwise highly subjective test.

5. **Definition of "securities"**

Under section 20AC(2) transactions which constitute "dealings in securities" (as defined under the Securities and Futures Ordinance ("**SFO**")) conducted by offshore funds with certain qualified persons will be subject to the Exemption Provisions.

Although the term "securities" is quite widely defined in the SFO, it has excluded shares in private companies which most offshore "private equity start-up" funds may typically invest into. In addition, there are other types of transactions which offshore hedge funds may transact in, for example, credit derivatives, which the current definition of "security" in the SFO may not cover. In order to provide a more certain and embracing exemption regime to the offshore funds, we believe that the definition of "securities" in the Bill should be extended to cover private company shares and other derivative instruments.

6. **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.

7. **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.

8. **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.

9. **Definitions of Associates**

We do not think a broad definition of the term "associate" will help compliance. This term should be more narrowly 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.

If you have any question concerning the above, please contact James Walker (2825 8874) or Kenneth Leung (2826 3565).

Yours faithfully,

Clifford Chance