CPA
Hong Kong Institute of
Certified Public Accountants
香港會計師公會

24 October 2005

By fax (2537 1851) and by post

Our Ref.: C/TXG, M37517

Hon. James Tien Pei-chun
Chairman
Bills Committee on Revenue (Profits Tax
Exemption for Offshore Funds) Bill 2005
Legislative Council Secretariat
Legislative Council Building
8 Jackson Road
Central, Hong Kong

Dear Mr. Tien,

Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005

Thank you for inviting the Hong Kong Institute of Certified Public Accountants ("the Institute") to comment on the Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005 ("the Bill").

I am writing to convey the views of the Institute's Taxation Committee on the Bill, in the light also of the supplementary notes ("notes") issued by the Administration and dated 4 October 2005.

General

We are in favour of legislation to exempt offshore funds from profits tax. The Institute put forward a proposal for such legislation in its 1999/2000 budget proposals to the financial secretary and repeated it in budget submissions in --- subsequent years (see Appendix 1). We believe that the legislation should aim to reinforce Hong Kong's status as an international financial centre and its attractiveness as a base for a range of different funds catering primarily to offshore investors.

We support such legislation, in principle, although we have some comments on certain technical matters in the Bill, as further explained below.

We note that the Administration has made a number of changes to its proposals since they first emerged in early 2004. The proposals contained in the Bill should make the situation more certain for funds that operate primarily outside of Hong Kong, although it may not give as much assistance to some smaller funds that are locally-operated, in terms of their central management and control, in their efforts to market to offshore investors.

4th Floor, Tower Two, Lippo Centre,
89 Queensway, Hong Kong
香港金鐘道89號力寶中心二座四樓

Tel 電話 : (852) 2287 7228
Fax 傳真 : (852) 2865 6776
(852) 2865 6603

Web 網址 : www.hkicpa.org.hk
E-mail 電郵 : hkicpa@hkicpa.org.hk

--- The Institute expressed detailed views on earlier consultations by the Administration on the exemption of offshore funds from profits tax. Copies of our submissions dated 31 January 2005 and 25 February 2004 are attached (Appendix 2). Some, although not all, of the points contained in the Institute's submissions have been dealt with.

Exemption should be granted to funds without regard to their residency

As indicated in our submission of 31 January 2005, our preferred approach would have been for the exemption from profits tax to apply depending upon the location of the investors in the fund, without regard to the residency of the fund itself. However, we acknowledge that, if such an approach is not based on the residency of the immediate investors in the fund, it can become complicated to administer. We understand that this was the general feedback on an earlier proposal put forward by the Administration, which was based on the exemption of the residency of the beneficial owners.

Detailed comments

Practical problems of applying the residency test of central management and control

Turning to the approach adopted in the Bill, we have concerns that introducing the concept of "central management and control" into the legislation and determining the residency of a corporation, partnership and trustee of a trust estate by reference to this concept, without defining it more specifically, would add complexity and uncertainty to the territorial taxation system in Hong Kong, and result in the need for complicated fact-finding.

We appreciate that new examples, based on example 7, have been included in the latest version of the notes (i.e., examples 8 and 9), where the investment vehicle has a majority of the board of directors or has general partners based outside Hong Kong, and that the activities undertaken will be considered as a whole in determining whether the investment vehicle is resident in Hong Kong.

The new examples will give additional assurance, although there may also be individual cases where uncertainty arises as to whether the "offshore" structure of a particular fund will be regarded by the Inland Revenue Department ("IRD") as having real substance. In some cases this could discourage funds from employing Hong Kong-based fund managers in the first place or from relocating fund managers to Hong Kong.

Therefore, the identification of whether a person is to be regarded as a Hong Kong resident or non-resident person is a fundamental feature of the Bill. The proposed section 20AB(2) of the Inland Revenue Ordinance ("IRO") includes definitions of a "resident person".

Natural persons

Subsection 20AB(2)(a), which sets out the definition of a resident person, provides, inter alia, that, in relation to any year of assessment, a person is to be regarded as a resident person:

"(a) where the person is a natural person who is not a trustee of a trust estate, the person-
(i) ordinarily resides in Hong Kong in that year of assessment; or
(ii) stays in Hong Kong for a period or a number of periods amounting to more than 180 days during that year of assessment or for a period or a number of periods amounting to more than 300 days in 2 consecutive years of assessment one of which is that year of assessment;"

We note that there are two tests currently used by the IRD for different purposes under the IRO to determine the number of days spent in or out of Hong Kong. Under the circumstances, the test for determining days in or out of Hong Kong under the proposed s20AB(2) needs to be made clear.

Other persons

Where the person is not a natural person, s20AB(2) sets out the definition of "a resident person" in subsections (b), (c) and (d), all of which involve the determination of "central management and control". In the case of subsection (b), a corporation (that is not a trustee of a trust estate) will be resident in Hong Kong if "the central management and control of the corporation is exercised in Hong Kong in that year of assessment". However, there is no definition or clarification in the Bill as to how "central management and control" is to be determined.

Paragraph 5 of the notes attempts to deal with the question of central management and control. However, this initially states that the central management and control will be exercised at the "highest level of control of the business of the company", but thereafter appears to make references to more subjective factors that are not further explained.

The lack of a clear definition of whether a non-natural person is resident in Hong Kong is a shortcoming in the proposed legislation, which could lead to disputes in determining whether such a person is centrally controlled and managed, and so resident, in Hong Kong.

Seeking to address this through IRD Departmental Interpretation and Practice Notes ("DIPN") could compound the uncertainty. In the context of DIPN No.10, for example, which relates to the charge to salaries tax under s8, IRO, the concept of central management and control is also used in considering whether an employer is resident outside Hong Kong. However, in practice, it seems that sometimes having a "place of residence" has been regarded as being sufficient to satisfy the test of central management and control. Thus, overseas companies that operate a branch in Hong Kong, even though their head office and substantial operations may be located outside Hong Kong, may be treated as falling within the definition of being resident in Hong Kong.

We suggest, therefore, that the key concepts of residence and central management and control, should, as far as possible, be clarified in the legislation and should not be left to be determined simply by reference to practice.

Central Management and Control

As the notes indicate that the central management and control of a company refers to the highest level of control of the business of the company, it is for consideration whether the definition of central management and control of a company should, for example, refer to the place where the directors hold their board meetings or, in the case where the directors have delegated effective control of the business to one or more directors, the place where the director(s) exercises that power.

A similar definition could be applied in the case of partnership, by reference to where the partners hold their meetings, with the proviso that, where one partner, such as a senior partner or managing partner, or a management committee, has been given effective control of the management of the partnership, control and management should be considered to be where the individual(s) exercises that power.

Similarly, in the case of a trustee of a trust estate the determination of control and management could be by reference to the central control and management of the trustee company (see above), where the trustee is a company, or the place where the trustee exercises his power if the trustee is a natural person.

Application of deeming provisions to individuals

Under the deeming provisions, any resident investor who has a 30% or more interest in an exempt fund would generally be liable to Hong Kong profits tax in respect of Hong Kong-sourced trading income arising from specified transactions. However, currently, resident individuals are rarely subject to profits tax on similar transactions unless they are regarded as being closely connected with the securities industry and, as such, regarded as engaging in securities trading. Given that it is the normal practice in Hong Kong not to impose taxation where an individual engages in such securities transactions, we have some doubt as to whether it is appropriate to subject resident individuals to tax under the deeming provisions in respect of similar income accruing to an investment fund.

Conversely, resident corporations are currently subject to profits tax on securities trading. We understand that it is the Administration's concern that these resident corporations might take advantage of the exemption provisions to avoid paying profits tax on such income. Accordingly, we would suggest that consideration be given to applying the deeming provisions only to resident corporations and to excluding resident individuals having a direct beneficial interest in an exempt fund.

The deeming provisions could perhaps be applied to the resident individuals who are associated with exempt funds, on the basis that they could be regarded as being closely connected with the securities industry (with the exception, as proposed in paragraphs 22-23 of the notes, of individuals, who, as the holders of management shares, are not entitled to participate in the fund's profits or in any distribution of the fund's assets upon dissolution, other than a return of capital).

Scope of exemption

We welcome the undertaking from the Administration to re-examine whether the scope of qualified transactions is sufficiently wide (paragraphs 11-12 of the notes). At the same time, we would question whether the potential for abuse by, for example, injecting immovable/landed properties into a private company, is, on its own, adequate grounds to exclude all shares in private companies from the scope of the term "securities". In our view, it would be more reasonable to include shares in private companies within the scope of the term, except possibly for those companies that hold predominantly immovable property.

Double taxation resulting from the deeming provisions

We do not entirely agree with the analysis contained in paragraphs 24-27 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 sells the shares in the fund. This would appear to be a form of de facto double taxation.

More fundamentally, with reference to the example given in paragraph 25 of the notes, we believe that there is a difference between the application of the deeming provisions and the situation in which a resident sells shares in a listed company. 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 any 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 the 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

We doubt whether the analysis contained in paragraph 28-29 of the notes provides 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.

As genuine investments by Hong Kong resident investors in an offshore fund may fall foul of the proposed deeming provisions, the deeming provisions in the context of this legislation are not merely anti-avoidance in nature. In our view, therefore, Hong Kong investors caught by these provisions should, where appropriate, be able to claim a tax loss.

Deductions of expenses incurred in generating deemed profits

We would suggest that expenses incurred by a resident investor in generating the deemed profits should be deductible in computing the profits chargeable on the resident investor.

We hope that you find our comments above to be constructive. If you have any questions on this submission, please feel free to contact me at peter@hkicpa.org.hk or on 2287 7084.

Yours sincerely,

Peter Tisman

Peter Tisman
Director, Specialist Practices

PMT/JT/ay
Encls.

c.c. Secretary for Financial Services and the Treasury (Attn: Mr. Ivanhoe Chang)
(Fax no.: 2868 5279)

Appendix 1

Extract from 1999/2000 Budget Proposals

Extension of exemption for mutual fund corporations

The existing exemption from profits tax for overseas mutual fund corporations and similar vehicles is restricted to those corporations that are widely-held and subject to an acceptable overseas regulatory authority. Many overseas mutual fund corporations promoted by renowned overseas financial institutions for their overseas private clients are neither widely-held nor subject to regulatory supervision and as such are not within the exemption. Nonetheless, they are often self-regulated to high standards and have investment potential in hundreds of millions if not billions of US dollars. As they are not specifically exempt from Hong Kong tax there is a concern that by locating fund managers and/or investment advisers in Hong Kong, depending on their functions in Hong Kong, which very often cannot be predetermined with precision, the mutual fund corporation may be exposed to Hong Kong profits tax. While very often such exposure may be considered to be more technical than real, it nonetheless must be identified and formally advised to potential overseas investors in the Initial Offering Document for the fund. Because of the uncertainty this can create in the minds of investors, promoters of the funds are often deterred from locating the related fund management activities here.

In order to further encourage and promote the expansion of fund management activities in Hong Kong, we would recommend that the restricted exemption at present applying to mutual fund corporations and similar vehicles be expanded to embrace mutual fund corporations of the nature described above.

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Appendix 2

BY FAX AND BY POST
(2530 5921)

Our Ref.: C/TXG, M33043

31 January 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 Sirs,

Consultation Paper on Exemption of Offshore Funds from Profits Tax

Thank you for inviting the Hong Kong Institute of Certified Public Accountants (HKICPA) to comment on the *Consultation Paper on Exemption of Offshore Funds from Profits Tax* issued in December 2004 ("the consultation paper"). Our views are set out below.

General comments

To put into effect the government's announcement in the 2003/04 Budget to exempt offshore funds from profits tax, the proposed legislation is intended to reinforce Hong Kong's status as an international financial centre by increasing its attraction to offshore fund managers and bringing Hong Kong into line with other major international financial centres, where offshore funds are generally not subject to tax. As such, we believe that it is important for any such legislation to be effective and workable in practice and, generally, to give an appropriate signal to the financial markets.

We note that under the revised approach put forward by the Administration, two sets of provisions would be introduced into the Inland Revenue Ordinance ("IRO") – the Exemption Provisions and the Deeming Provisions. We also note that the proposals are similar to those outlined to representatives of the HKICPA at a meeting with the Administration held on 8 December 2004.

Generally, we consider the revised approach to be an improvement over the proposals under the former approach; in particular, we support the dropping of the proposed rules for tracing beneficial interests in the fund vehicle. However, we have concerns regarding specific aspects of the revised approach and suggest that clarification is required in relation to certain key terms referred to under the revised approach.

4th Floor, Tower Two, Lippo Centre,
89 Queensway, Hong Kong
香港金鐘道89號力寶中心二座四樓

Tel 電話 : (852) 2287 7228
Fax 傳真 : (852) 2865 6776
(852) 2865 6603

Web 網址 : www.hkicpa.org.hk
E-mail 電郵 : hkicpa@hkicpa.org.hk

Specific comments

Exemption Provisions

(a) *Definition of "resident/non-resident fund"*

The term "resident" is key to the Exemption Provisions and the Deeming Provisions. Specifically, the Exemption Provisions would grant profits tax exemption to a non-resident (including an individual, a partnership, a trustee and a corporation) without regard to the composition of its beneficial owners. The Deeming Provisions would deem assessable profits on a resident holding beneficial interest in a tax-exempt non-resident under certain circumstances. Yet the term "resident" has not been defined in the existing provisions of the IRO and no suggested definition has been put forward in the consultation paper.

Typically, as pointed out in our submission on the former approach, dated 25 February 2004, many offshore funds that carry out securities trading transactions in Hong Kong are formed, promoted and operated by Hong Kong-based investment advisers/fund managers. These managers and funds generally have common directors or principals. It is the norm for these managers to have an ownership interest in the offshore funds.

Under such arrangements, the Hong Kong-based managers would be able to exercise the day-to-day management and control of the funds, but it is the investors who would be entitled to the capital and income of the fund.

We are concerned that if the residency of a corporation is to be determined by reference to, for example, the place where it is centrally managed and controlled or otherwise carrying on business, funds that are managed by Hong Kong-based managers would be considered to be "resident" in Hong Kong and, therefore, would fall outside the scope of the Exemption Provisions. We believe that a fund that is managed, controlled or operated by Hong Kong-licensed investment advisers/fund managers should not, simply by virtue that reason, be regarded as "resident" for the purpose of the Exemption Provisions.

We would suggest instead that consideration be given to basing the exemption on a test that looks only to the residency of the *immediate investors* in the fund. For example, in the case of a company, provided that it is incorporated outside of Hong Kong and the percentage ownership of the non-resident investors attains a certain threshold, say 80%, the fund should qualify as tax-exempt. This would not be inconsistent with the tests adopted by other jurisdictions and would be an appropriate way to ensure that the exemption would apply only to funds that are offshore in nature.

(b) *Section 20AA, IRO, brokers/investment advisers*

As in the case of the former approach, profits qualified for exemption under the revised approach are profits derived from securities trading transactions carried out in Hong Kong through s.20AA, IRO, brokers/investment advisers.

We believe that the proposed application of all the requirements of s.20AA would mean that many offshore funds would not be eligible for the exemption. Specifically, s.20AA(3) requires, inter alia, that the approved investment adviser must not have been an associate of the non-resident person during the year of assessment and that the approved investment adviser must be acting for the non-resident person in an independent capacity. However, as we have previously pointed out, since many of the offshore funds are formed, promoted and operated by investment advisers/fund managers, they effectively control the fund corporations or entities, by sharing with them common directors/principal officers, etc. Thus, the proposed application of all the requirements of s.20AA would render many offshore funds ineligible for the exemption.

We reiterate the view expressed in our previous submission that the “associate” test under s.20AA, which is unduly restrictive and onerous, should not limit the operation of the exemption.

To enhance the attractiveness of Hong Kong as a place for fund managers to set up their operations, therefore, we recommend removing the nexus between the Exemption Provisions and s.20AA in its entirety or, as a minimum, between the provisions and the “associate” test under s.20AA.

(c) Non-resident person carrying on any other business in Hong Kong

The consultation paper suggests that the availability of the profits tax exemption is subject to the requirement that the non-resident person must not carry on any other business in Hong Kong.

While the rationale behind this proposed requirement may be to extend the exemption only to funds that are offshore by nature, this requirement may be difficult to satisfy in practice, as it is common for funds to appoint Hong Kong administrators and custodians as agents of the non-resident fund. Accordingly, this requirement could affect the tax-exempt status of some non-resident funds, if such ancillary administrative and custodian services were to be regarded as amounting to the carrying on of a business by the fund in Hong Kong. For Hong Kong profits tax purposes, it is generally accepted that very little needs to be performed on behalf of a non-resident in order for that non-resident to be considered as carrying on business in Hong Kong.

In our view, the fact that miscellaneous and ancillary services are performed on behalf of an otherwise non-resident fund in Hong Kong should not adversely affect the overall tax-exempt status of the fund.

One possible alternative would be to set out a list of permissible ancillary services that the fund could undertake in Hong Kong without impacting on the fund's non-resident and exempt status, possibly in a Departmental Interpretation and Practice Note on the intended application of the proposed provisions.

(d) *Definition of securities*

The consultation paper seems to suggest that if a fund is to make an investment, other than in securities that fall within the definition of "securities" in Schedule 1 to the Securities and Futures Ordinance (Cap.571), such an investment could taint the entire exempt status of the fund. The term "securities" as defined may not include, for example, certain typical income of a fund, such as stock borrowing and lending fees, interest and foreign currency income. Further, it is unclear from the consultation paper whether, in the case of a fund with investment in "securities" as defined and other investments, the exemption would continue to apply to the profits from investments that in fact fall within the definition of "securities".

We suggest that the types of exempted income should be suitably broadened to cover all types of income incidental to securities trading, so as to reflect the legislative intent of the exemption.

We also believe that the legislation should be drafted to provide that the fact that certain investments did not fall within the definition of "securities" would not taint the exemption status of the fund in prescribed circumstances, or otherwise affect the exemption of profits from investments falling within the definition of "securities".

One option would be to introduce a *de minimis* test in the legislation, such that the overall tax-exempt status of the fund would not be affected by the fund's Hong Kong investments that did not fall within the definition of "securities", where the *de minimis* test was satisfied.

<u>Deeming Provisions</u>

(e) *Beneficial interest held by a resident investor*

Based on the outline of the Deeming Provisions in the consultation paper, we understand that such provisions, if enacted, would apply to a resident investor, who alone or with his associates, holds a certain percentage, say, 30% or more of the beneficial interest in a tax-exempt non-resident.

We have doubts about the effect of introducing Deeming Provisions as part of the proposed legislative framework. We would suggest that the provisions, as outlined, are potentially complex and may be at odds with the current Hong Kong tax law, in that, e.g., Hong Kong-resident investors may become subject to tax on Hong Kong-sourced trading profits derived by another entity (i.e. the fund).

Furthermore, while resident corporations are currently subject to profits tax on their securities trading income, resident individuals are rarely subject to profits tax on their income from securities. In view of the purpose of the proposed exemption to reinforce the status of Hong Kong as an international financial centre, it may not be warranted to subject resident individuals to tax under the Deeming Provisions in respect of the securities trading income of their invested funds.

In addition, we foresee practical difficulties in computing the level of ownership of a Hong Kong resident investor in a tax-exempt non-resident, in situations where the resident investor is required to take account of interests held directly or indirectly by associates.

(f) *Deemed assessable profits*

It appears that the Deeming Provisions may operate whether or not any actual distributions have been made by the non-resident fund to a Hong Kong resident investor. This could mean that the resident investor would be subject to tax on unrealised profits, which the resident has not derived and may never derive (e.g. if the investor disposed of its interest in the fund prior to receiving a distribution). Also, we envisage a potential risk of double taxation arising if the resident might be assessed on deemed profits and again on the disposal of its investment in the fund.

For the above reasons, we have some reservations over the operation of the Deeming Provisions and over any perceived necessity of applying such provisions to counteract "round tripping" transactions. We believe that the existing provisions of the IRO should already be sufficient to address such arrangements.

Conclusion

As indicated above, we find the broad concept behind the Exemption Provisions as set out under the revised approach to be an improvement over the previous approach. However, the way in which "resident" and "non-resident" funds will be defined is fundamental to the concept and needs to be clarified. We also suggest consideration of the alternative approach of basing the proposed exemption on a test that looks only to the residency of the *immediate investors* in the fund.

We have doubts about broad implications and practical effects of introducing the Deeming Provisions.

I hope that you find our comments to be constructive. If you have any questions in relation to this submission, please do not hesitate to contact me at peter@hkicpa.org.hk or on 2287 7084.

Yours faithfully,

Peter Tisman

PETER TISMAN
TECHNICAL DIRECTOR
(BUSINESS MEMEBRS & SPECIALIST PRACTICES)

PMT/JT/ay

HONG KONG SOCIETY OF ACCOUNTANTS
(Incorporated by the Professional Accountants Ordinance, Cap. 50)

香港會計師公會

BY FAX AND BY POST
(2861 1494)

Our Ref.: C/TXM, M25839

25 February 2004

Financial Services Branch,
Financial Services and the Treasury Bureau,
18/F., Admiralty Centre Tower I,
18 Harcourt Road
Admiralty,
Hong Kong.

(Attn: Consultation on Exemption of Offshore Funds from Profits Tax)

Dear Sirs,

Consultation on Exemption of Offshore Funds from Profits Tax

Thank you for inviting the views of the Hong Kong Society of Accountants (HKSA) on the proposed amendments to the Inland Revenue Ordinance ("IRO"), to put into effect the Government's announcement in the 2003/04 Budget to exempt offshore funds from profits tax.

The draft legislation proposes to exempt the profits derived by offshore funds by linking the new provision (section 20AB of the IRO) with the existing provisions applying to approved investment advisors and brokers (s20AA, which exempts brokers and approved investment advisors from being treated as agents of non-resident persons, provided certain conditions are met). Accordingly, under the proposed legislation, a non-resident person will be exempt from profits tax on profits derived from transactions undertaken through an agent who is a broker or an approved investment advisor where certain conditions are satisfied.

General comments

The aim of the proposed legislation is to reinforce Hong Kong's status as an international financial centre, by increasing its attraction to offshore fund managers and bringing Hong Kong into line with other major international financial centres. This being the case, it is important that any legislation introduced to achieve this purpose is workable and effective and that, generally, it will convey the appropriate message to the financial markets. We have doubts as to whether the proposed legislation will meet these requirements and we believe that, although statutory changes to implement the 2003/04 Budget announcement have been anticipated for some time, it would be better to delay their introduction for a further period of time, rather than proceeding with amendments to the IRO that may not have the desired effect.

The Society has the following general observations in respect of the proposed legislative provisions:

香港金鐘道八十九號力寶中心二座四樓

4th Floor, Tower Two, Lippo Centre, 89 Queensway, Hong Kong.
Tel: 2287 7228 Fax: 2865 6603 / 2865 6776
Web: http://www.hksa.org.hk E-mail: hksa@hksa.org.hk

- The proposed exemption provisions will have retrospective effect from the 1997/98 year of assessment and will apply to funds, individuals, partnerships, trusts and corporations that are resident outside of Hong Kong. The retrospective operation of the legislation is presumably designed to offer additional comfort and certainty to funds that may have had previous profits tax exposure in Hong Kong.

- To meet the non-resident threshold, the draft legislation imposes a requirement that non-residents must hold at least an 80% interest in the offshore fund in order to qualify. The implications of this requirement are discussed under the heading "Specific comments" below.

- Under the current draft proposals, the non-resident requirements seek to lift the veil of corporate ownership to identify the individual beneficial ownership. The test to be applied in this respect is unclear in the context of listed groups and will require further clarification.

- An offshore fund will also need to satisfy the existing conditions for exemption under s20AA of the IRO. Section 20AA (2) requires, inter alia, that the broker should not have been an associate of the non-resident client during the year of assessment. Section 20AA(3) requires, inter alia, that for dealings between an approved investment adviser and a non-resident, the parties must be dealing with each other in an independent capacity and must not be associated.

<u>Specific responses to consultation questions</u>

The Society's comments in respect of the specific questions raised in the consultation paper are as set out below.

(a) *As far as tax incentives are concerned, do you agree that the proposed legislation is sufficient for attracting offshore funds to Hong Kong and enabling Hong Kong to compete with other countries with similar exemptions on a level playing field? If not, why not and what other aspects do we need to consider?*

While the proposed s20AB of the IRO is designed to offer an exemption from profits tax to offshore funds, many offshore funds may not fall within the proposed exemption as it is currently drafted.

Currently, the proposed exemption requires offshore funds to meet the non-resident percentage threshold (not less than 80%) and to comply with the existing provisions of s20AA of the IRO. The Society believes that this exemption is likely to be inadequate in practice as offshore funds that satisfy the 80/20 criterion will not be exempt if the qualifying concessions of s20AA are not also fulfilled.

Specifically, s20AA(3) requires, inter alia, that the approved investment adviser must not have been an associate of the non-resident person during the year of assessment and that the approved investment adviser must be acting for the non-resident person in an independent capacity.

Typically, since many of the offshore funds are formed, promoted and operated by investment advisers/fund managers, they effectively control the fund corporations or entities by sharing with them common directors/principal officers etc, even though they may only have a minimal or no beneficial interest in the funds. Thus, by having Hong Kong based directors/principal officers, the funds may not be regarded as non-residents of Hong Kong and, therefore, not fall within scope of the exemption under the proposed s20AB.

In addition, transactions of these offshore funds carried out through local investment advisers/fund managers also appear in most cases not to be covered by section 20AA and, therefore, the proposed section 20AB, on the basis that the investment advisers/fund managers are either associates of the non-residents or they are not normally acting in an independent capacity for the non-residents.

Therefore, the legislation as drafted may not extend to a number of offshore funds. that have investment advisory operations in Hong Kong. It is unclear from the wording of s20AB of the IRO whether this is an intended effect contemplated by the drafters of the proposed legislation.

(b) *Do you think the proposed anti-avoidance provisions in section 20AB(2) are effective in preventing round-tripping of local funds from taking advantage of the tax exemption? If not, why not and what other elements should be included?*

As noted above, the anti-avoidance rules appear somewhat onerous and in practice would prevent the exemption being extended to offshore funds that should otherwise qualify. The Society believes that, as an alternative, therefore, the general anti-avoidance provisions in s61A of the IRO should be used to prevent round-tripping of local funds in order to take advantage of the tax exemption.

Under the current draft proposals, the non-resident threshold test requires corporate ownership (or trust, or partnership, as the case may be) to be made transparent to reveal the individual beneficial ownership. How this "look-through" test will work is unclear in the context of listed groups and will require further clarification. For instance, it would be highly onerous, or even impracticable, for a multinational listed company to have to furnish information regarding the ultimate individual shareholders of its holding company, in order to demonstrate that the 80% non-resident threshold has been satisfied. The Society is of the view that any such test would need to be significantly simplified in its application to listed or publicly-owned companies.

(c) *Do you consider the 80% threshold in section 20AB(2)(b) reasonable? If not, why not and what is the threshold you consider appropriate?*

While we note that the 80% non-resident threshold, as proposed under s20AB(2)(b), has been adopted in Singapore, we are not convinced that this is the appropriate threshold, rather than, say, a simple majority. We are also not convinced, whatever ownership threshold is adopted, that it should be applied on an "at any time" basis rather than on the basis of, e.g. an average over a period. The Society believes that more discussion is called for on these aspects of the proposals, which is one reason why we are calling for the introduction of the proposals to be deferred.

(d) *Would you have difficulty in complying with the record-keeping requirement options set out in paragraph 15? If yes, please provide details about the difficulties and your other suggestions which can achieve the same purpose.*

The Society considers the record-keeping requirements set out under paragraph 15 to be potentially onerous on the broker/approved investment adviser, particularly option (a) under which the types of records as set out under Annex B are required to be maintained. This would in practice necessitate a great deal of administration and information-collecting on the part of the broker/approved investment adviser.

Option (b), which requires the broker/approved investment adviser to obtain confirmations from all non-resident clients that the criteria for tax exemption are met, may be less onerous for the broker/approved investment adviser. However, it would appear to require the non-resident client to understand and interpret Hong Kong law and, in this respect, we note that, for example, the terms "Hong Kong resident"/"non-Hong Kong resident" are not defined for the purposes of the proposed new s20AB. There are also the practical difficulties, referred to above, of determining beneficial ownership in the case of large listed companies

Additional comments on the legislative proposals

In the light of the above, the Society's view is that the shortcomings in the proposed legislative amendments could result in their being ineffective in practice. Our further comments below include some suggestions for modifications to the proposed legislative amendments that could help to address the deficiencies in the current proposals.

Operation of the "look-through" test

One major deficiency in the proposed legislation relates to the operation of the proposed tracing rules to determine the residency of an investor. As we have pointed out above, under the draft legislation, the determination of the "non-resident" status of fund requires ascertaining the ultimate individual beneficial ownership. Although the proposed test may not be difficult to apply in simple corporate structures, its application in the context of more complex ownership structures would be difficult, if not unrealistic, in practice.

Furthermore, under the IRO, a person is generally only liable to profits tax if the person carries on business in Hong Kong and derives Hong Kong-sourced profits from that business. Therefore, it would seem to be questionable for the test to be concerned with traditional concepts of residency. Instead, it would be more appropriate for the test to be directed at identifying whether an investor is considered to be carrying on any other business in Hong Kong and so liable to tax. At the same time, the question arises, as to why "Hong Kong residents" that conduct no other business activities in Hong Kong should be limited to beneficially owning no more than 20% of a relevant fund?

The Society believes that the "round-tripping" rules should operate to prevent persons, who otherwise carry on business in Hong Kong, from escaping a liability to Hong Kong tax through an offshore fund. As such, as an alternative to the residency test, therefore, consideration could be given to adopting a test of determining whether an investor, regardless of residency, is "carrying on any other business in Hong Kong", either in its own right, or through an agent. This could be given effect by, for example, requiring fund managers to obtain a statutory declaration from investors at the time that they make the investment.

Removing the nexus between sections 20AB and 20AA

Another potentially serious flaw in the proposed exemption under s20AB arises from linking the exemption to the conditions required to satisfy s20AA. The draft proposal currently provides that an offshore fund would need to satisfy all of the existing conditions of s20AA of the IRO in addition to the non-resident threshold in order to qualify for exemption.

The conditions under s20AA (3) require, inter alia, that the approved investment adviser must not have been an associate of the non-resident during the year of assessment and that the approved investment adviser must be acting for the non-resident person in an independent capacity. An "associate" is defined very broadly under s20AA (6). For the purposes of the currently proposed exemption, therefore, as the operation of s20AB is conditional upon the satisfaction of the requirements in s20AA, where an offshore fund and the Hong Kong broker or approved investment adviser are associated, then the profits tax exemption would not apply to the investment vehicle, even if the non-resident threshold of s20AB was satisfied.

The Society is of the view that the "associate" test under s20AA, which is unduly restrictive and onerous, should not limit the operation of s20AB.

With a view to preventing round-tripping, which is the primary tax mischief that the anti-avoidance provisions in s20AB are designed to prevent, the Society considers that it would be more effective to remove the s20AA "associate" and "independence" tests in the application of s20AB and rely primarily on the test of whether the relevant parties "carry on any other business in Hong Kong". Other fund management centres (e.g. Singapore) provide that an offshore fund qualifies for exemption if it satisfies a non-residency threshold. The fact that the broker or approved investment adviser are associated entities, or may not be acting in an independent capacity, does not affect the application of the exemption. Moreover, as indicated above, the Society believes that, as an alternative, the general anti-avoidance provisions in s61A may be applied to prevent round-tripping of local funds to take advantage of the tax exemption.

However, as a policy matter, consideration might be given to introducing a provision to the effect that, where a Hong Kong-based investment adviser/fund manager (including any of its associated companies) owns more than a certain proportion of the capital of an offshore fund (e.g. 20%) for an extended period, that portion of the income of the fund that is attributable to the investment adviser/fund manager's share, should be brought into the Hong Kong's tax net.

If, ultimately, the "associate" and "independence" requirements were not to be applied to an offshore fund, which otherwise satisfied the non-resident threshold, the linking of the operation of s20AB to s20AA would serve no substantive purpose; in which case, s20AB as currently proposed could be redrafted to remove the requirement that, for the exemption to apply, the conditions in s20AA must also be satisfied. In this were to be done, the redrafted exemption provision could be introduced into the existing s26A of the IRO, which applies to instances where certain profits are excluded from profits tax. Section 26A seems to be a more appropriate provision in which to incorporate the offshore fund exemption.

Other matters

Procedure of confirmation of eligibility by non-resident investors

The Society has also been invited to comment on the above subject in a separate letter of 13 February 2004 from the Permanent Secretary for Financial Services and the Treasury (Financial Services). Our view of the proposed procedure is that, prima facie, the procedure appears to be relatively straightforward from the point of view of brokers/approved investment advisers. The reservations that the Society has about the procedure are reflected in our response to question (d) above, particularly as this relates to option (b). It also needs to be clarified whether, under the proposed procedure, brokers/approved investment advisers would be expected to retain any supporting evidence in respect of e.g., the questions of "association" and "independence" under s20AA(3), or whether the onus and liability would be entirely on the non-resident clients to determine and declare such matters.

We should emphasise that the Society's comments on the procedure are subject to the Society's overall views on the proposed legislation, in relation to which our concerns are reflected in this submission.

Abolition of estate duty on investments in exempted funds

Although not directly related to the legislation at hand, given that the objective of the proposed legislative changes is to enhance Hong Kong's position as an international financial centre, we also take this opportunity to reiterate a proposal made in our Budget Proposals 2004/05, submitted to the Financial Secretary in December 2003. We believe that the abolition of estate duty would encourage the further development of private banking and reinforce Hong Kong's position as a major financial centre. More specifically, in relation to offshore funds, we would suggest that estate duty be abolished at least on investments in funds exempted from profits tax under the IRO.

If you have any questions on this submission, please do not hesitate to contact me by telephone (on 2287 7084) or email (at peter@hksa.org.hk).

Yours faithfully,

Peter Tisman

PETER TISMAN
TECHNICAL DIRECTOR
(BUSINESS MEMBERS & SPECIALIST PRACTICES)

PMT/ay