HK IFA 香港投資基金公會

**Hong Kong Investment Funds Association**

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Ms. Debbie Yau
Clerk to Bills Committee
Legislative Council Building
8 Jackson Road
Central, Hong Kong

Dear Ms. Yau

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

We refer to the Invitation for Submissions dated 22 July 2005 issued by the Chairman of the Bills Committee with respect to the Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005 (the "Bill"). The Bill seeks to amend the Inland Revenue Ordinance (Cap. 112) (the "IRO") to give legal effect to the proposal of providing profits tax exemption for offshore funds ("the Exemption Provision").

HKIFA very much welcomes the Bill as it seeks to exempt offshore funds from Hong Kong taxation. It also is a reflection of the Hong Kong SAR Government's commitment to position Hong Kong as a fund management centre, and gives effect to the Inland Revenue Department's ("the IRD") statement of practice that "it would be unusual for the transactions of a non-resident through a broker or investment adviser to amount, in themselves, to the carrying on of a trade, profession or business"[1], a fundamental requirement for taxation in Hong Kong. This statement, and the practice of the IRD over the years on which it is based, has been relied upon by foreign investors and the Hong Kong asset management industry. Despite this statement from the IRD in 1998, there is a real need for the proposed exemption. Firstly, there have been some moves in recent years by the IRD not to follow their stated practice with their attempting to tax some foreign "collective investment schemes" ("CISs"). Secondly, there is a need to provide legal certainty of exemption as under the current law there is a technical risk of Hong Kong tax for certain foreign investors. Such countries as Singapore, the United Kingdom and the United States already provide this legal certainty of exemption. In today's competitive global environment, not having such certainty puts Hong Kong at a significant disadvantage, particularly in relation to our nearest competitor, Singapore.

[1] Departmental Interpretation and Practice Note No. 30: Profits Tax: Section 20AA – Persons not Treated as Agents, Commissioner of Inland Revenue, August 1998.

However, there are a number of issues and concerns that our members have with respect to the draft Bill. Two of these matters (Items I. and II. below) go to the very heart of the operation of the Exemption Provision. We believe it is critical to resolve these issues so as to enable the industry to benefit from the exemption provided. We have also provided workable solutions that we trust will help address the issues raised.

## I. Section 20AB(2) Definition of "Non-resident person"

A key requirement of the Exemption is that the foreign investor must be a "non-resident". It is vital that "non-resident" is not defined narrowly, or interpreted narrowly in practice. If it is, it will render the Exemption Provision largely ineffective. An area of uncertainty is the definition of non-resident person in Section 20AB(3). A person is a non-resident person if he is not a resident person defined under Section 20AB(2). A resident person can be a natural person who ordinarily resides in Hong Kong or stays in Hong Kong for certain number of days; or a corporation, a partnership or a trustee of a trust estate that exercises its central management and control in Hong Kong.

It is fundamental to the effectiveness of the Exemption that foreign investors, the asset management industry and the IRD clearly understand what will determine the place of "central management and control" for these purposes. This can be accomplished by including a definition of management and control in the legislation. We believe that management and control should be defined as the place where highest level decisions are made covering general policy, strategic direction, major agreements and financial matters, and reviewing overall performance. An alternative to including this definition in the legislation is for the IRD to make a statement by way of a practice note that this is their understanding of the meaning of management and control. We understand that it is the IRD's intention to issue a note along these lines. However, the legislative approach is preferred as it provides considerably more certainty as a practice note has no legal force.

## II. Section 20AC(2)(a) Scope of exemption

Fundamental to the Exemption Provision is the specification of the income to be exempted in the circumstances that the provision applies. The effectiveness of the Exemption Provision will largely depend on the specification covering income from the types of transactions CISs typically enter into. The Exemption provision currently only exempts profits arising from transactions constituting "a dealing in securities". This is defined by taking three out of the nine definitions of regulated activities from Schedule 5 of the SFO, namely Type 1 "dealing in securities", Type 2 "dealing in futures contracts" and Type 3 "leveraged foreign exchange trading".

The SFO in this instance has a specific purpose of regulating stipulated activities, and Type1, Type 2 and Type 3 activities do not cover many transactions typically entered into by CISs. Further, these three definitions do not cover a considerable range of transactions of a type which would be allowed if the CISs were regulated by the Securities and Futures Commission ("SFC").

Examples of transactions commonly entered into by CISs and which apparently do not fall within the current definitions are:

(a) futures transactions which are not made under the rules of a futures market – This would include many over the counter derivatives. As an example CISs can enter into derivatives contracts with merchant banks which track market indexes.

(b) stock lending fees and manufactured dividends.

(c) many types of derivatives including swaps and hedges of equity and debt instruments, "participation products" which give the CIS all the economic attributes of holding a stock without any interest in the actual stock, over the counter derivatives which do not involve actual securities etc.

(d) non-leveraged foreign exchange trading, commodities, insurance policies etc.

(e) cash deposits.

(f) bills of exchange, promissory notes, and non negotiable and non transferable debentures.

(g) private equities and debentures.

As can be seen from the above examples, such a "specific definitions" approach leaves significant areas which are not exempted. This was previously found to be the case in relation to the Section 26(1A) IRO exemption of profits for SFC authorised CISs and foreign widely held CISs supervised in acceptable regulatory regimes. Government agreed with Industry representations in 1998 and moved away from the limited specific definition approach to a general definition of income derived by CISs carried on in accordance with their constitutive documents as approved by the SFC or the supervisory authority within the acceptable regulatory regime.

We strongly recommend that the same approach be taken here to cover existing transactions commonly entered into by CISs and to accommodate future developments and products which CISs will enter into. A suggested approach for achieving this is to add to the definition of "dealings in securities" by including transactions of a type which are authorised under a Type 9 asset management licence under the SFO, namely transactions entered into in providing a service of managing a portfolio of securities or futures contracts for another person. This would add a general definition category, and should Government believe that profits from a particular type of transaction should not be included, then that type of transaction could be specified as an exception to this general category.

## III. Section 20AC(1)(b) Incidental transactions and Section 20AC(6) 5% exclusion of trading receipts from incidental transactions

Section 20AC(1)(b) of the Bill disallows a non-resident person from enjoying the Tax Exemption on profits from incidental transactions if the person's trading receipts from the incidental transactions exceed 5% of the total trading receipts from the exempt transactions and incidental transactions put together.

The following issues require clarification:

(a) With the current narrow definition of "dealing in securities" as analysed in Item II. above, it is likely that CISs will have considerable "incidental income" and therefore the proposed 5% limit will be easily exceeded. This position will be greatly ameliorated if a wider definition of "dealing in securities" is adopted.

(b) Income which is currently not taxable under the IRO should not be included as "incidental income" for the purposes of calculating the 5%. We understand that it is the intention of the IRD to address this point by way of a practice note stating that items of income which are currently not taxable eg dividends, interest derived on a deposit with an authorized institution in Hong Kong etc, will not be regarded as "incidental income".

## IV. Section 70AB Retroactive application of the Bill

We strongly support the retrospective application of the Exemption Provision, as currently drafted. There is a real need for retrospectivity for the following reasons:

(a) The IRD has had an unofficial policy of not taxing foreign funds using HK investment managers.

(b) The above practice was finally in 1998 publicly stated by the IRD at paragraph 5 in its Practice Note No. 30: Profits Tax: Section 20AA - Persons not Treated as Agents:

> "….it would be unusual for the transactions of a non-resident through a broker or investment adviser to amount, in themselves, to the carrying on of a trade, profession or business."

This practice note is still current.

(c) Failure to apply the exemption to the past 6 years would be inequitable and could have serious negative consequences:

(i) It would result in tax being applied to foreign investors in relation to only those past 6 years, as before that period (which is now time barred) investors would have benefited from the IRD's practice, and after the 6 year period investors would be covered by the new exemption.

(ii) This would go against the Practice Note quoted above, which investors and the

Hong Kong asset management industry have relied upon and which was issued to the public before the start of the 6 year period.

(iii) Significant investments are made into Hong Kong by CISs, into which investors frequently come and go. If they are to receive an assessment now in relation to past years, this will severely disadvantage those current investors who were not invested in the years the gains were made and are now having to bear the tax burden in relation to those past gains which they did not benefit from.

(iv) CISs would face very difficult valuation issues as their auditors would have to consider potential liabilities for back years.

(d) Hong Kong has a reputation for certain and simple tax law. Given that there was a practice not to tax and that it was published by the IRD in an official practice note, Hong Kong's reputation would be damaged if this practice is now ignored and CISs are taxed in relation to the past 6 years.

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We highly recommend the Bill to your members with our proposed amendments. We believe that the Government is determined to promote the wellbeing and growth of Hong Kong's investment management industry. We trust the Government will take the extra step to make the Bill a success, with the resolution of these important issues.

We trust you will find the above useful. Should you wish to discuss further with us any of the above comments, please contact us by telephone on 2537 9912 or by email at hkifa@hkifa.org.hk.

Yours truly,

Sally Wong
Executive Director