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

Summary of views in respect of the technical aspects of the proposed Committee Stage Amendments
(Position as at 13 January 2006)

	Views of organizations	Name of organization	Administration's responses
1	***General comments***		
1.1	◆ Supports the Bill. The Administration has addressed the principal concerns of the fund management industry.	CPA[1], HKAB[2], Joint submission[3]	◆ The supportive view is welcomed.
1.2	◆ The Committee Stage Amendments (CSAs) would achieve the policy objective of providing profits tax exemption for offshore funds. They adequately addressed the concerns that we have raised.	HKSbA[4]	◆ The supportive view is welcomed.
1.3	◆ The Revised Bill has adequately addressed the concerns raised by the investment management industry participants and other relevant interest parties.	PwC[5]	◆ The supportive view is welcomed. The Administration will consider taking on board those minor technical issues that are consistent with the express or implied provisions of the Bill in the DIPNs.

[1] CPA Australia, Hong Kong China Division
[2] Hong Kong Association of Banks
[3] Joint submission by the Capital Markets Association of Asia, Ernst & Young Tax Services Limited, Deloitte Touche Tohmatsu, Hong Kong Investment Funds Association, KPMG Tax Limited and the Alternative Investment Management Association Limited (Hong Kong Chapter)
[4] Hong Kong Stockbrokers Association
[5] PricewaterhouseCoopers Ltd.

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	◆ Offers full support for the Revised Bill which represents an important step towards developing Hong Kong as a financial centre on the global stage and encouraging further growth in the hugely important investment management industry here. ◆ There are a few minor technical issues that can be satisfactorily dealt with by a Departmental Interpretation Practice Note (DIPN) to be issued by the Inland Revenue Department (IRD). It has written to the Administration under separate cover in this regard.		
1.4	◆ We noted that the Bills Committee have not fully addressed issues raised during the consultation, notably the definition of central management and control, taxation of individuals under the deeming provisions, deemed loss and double taxation. However, we understand these were issues that the Government was firmly of the view that they would not be willing to consider or incorporate into the draft legislation. We also note that the buying/selling of equities in private companies incorporated in Hong Kong is intentionally excluded from the exemption and that the Government will not move away from their position. Nevertheless, we are pleased to note the CSA confirming/clarifying that the buying/selling of equities in private companies outside Hong Kong are transactions qualifying for exemption. ◆ Overall, we are supportive of the CSA and recommend the Bill as currently drafted for passage.	KPMG[6]	◆ Deputation's appreciation of the Administration's policy and its supportive view on the Bill are welcomed.

[6] KPMG Tax Limited

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1.5	◆ On balance, the Institute believes that the draft legislation with the improvements so far introduced will be workable and, on this basis, should be allowed to proceed. We should hope that the Administration remains mindful of the concerns referred to above, and their practical implications, once the legislation is in effect, and that, in due course, consideration will be given to the need for further legislative amendments to address some or all of these points.	HKICPA[7]	◆ The supportive view on the Bill is welcomed. The Administration will review the need for amendment of the legislation where necessary.
1.6	◆ No comments on the CSAs	LSHK[8]	◆ Noted.
2	***Exemption provisions – clause 2: proposed sections 20AC, 20AD***		
2.1	◆ The deeming provisions require Hong Kong based investors to in effect self assess themselves regarding investments in such Funds. Prefer to see the Bill enacted without any deeming provisions. They add new complexity to the tax system in Hong Kong and will probably not give rise to much tax revenue as such Hong Kong investors will be discouraged from making such investments by their new tax position. BCC understand that this is a "policy" decision that Hong Kong investors should pay and the situation is unlikely to change; but BCC cannot really understand why	BCC[9]	◆ The exemption provisions are intended to benefit non-residents only. This policy is in line with those of major overseas financial centres such as the UK and Singapore. The deeming provisions have to be enacted to deter residents from carrying out round-tripping (i.e. residents disguised as non-residents) to take advantage of the exemption, which is not intended for them. Without the deeming provisions to guard against round-tripping, a Hong Kong resident may avoid tax by simply carrying out securities trading transactions through a non-resident entity. It should be noted that the deeming provisions

[7] Hong Kong Institute of Certified Public Accountants
[8] Law Society of Hong Kong
[9] British Chamber of Commerce in Hong Kong

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	the Administration is so adamant about this.		do not create a new tax, but are for the prevention of loss of tax revenue.
3	***Deeming provisions- clause 2: proposed section 20AE***		
3.1	◆ Some flexibility should be allowed for a resident to escape from the deeming provision if the resident can justify that no round-tripping is involved, say through the advance ruling mechanism. ◆ This is particularly important, especially when there is an increasing trend of foreign investments into PRC enterprises and these enterprises are expected to be allowed to invest in the global securities market, including Hong Kong, through Qualified Domestic Institutional Investors (QDII) in the near future. A situation may occur that several of the foreign investors, who are associated and in aggregate hold over 30% interest in such a PRC enterprise, will find themselves caught by the deeming provision notwithstanding that they have no round-tripping intention. ◆ As a further example, if a PRC enterprise is put under a listing vehicle for Hong Kong IPO purpose, the listing vehicle will potentially be caught by the deeming provision. If there is no "escape" provision on the deeming provision, the deemed tax can only be avoided by locating the management and control of the listing vehicle outside Hong Kong which may or may not be practically feasible. This	ACCA[10]	◆ This issue has been fully deliberated previously. The administration of the deeming provisions by reference to the source of funds is impractical and open to abuse. During the first round consultation, most deputations expressed serious difficulties in ascertaining the identity of the ultimate investors, as well as their resident status, and raised much concern about the heavy compliance burden placed on brokers/investment advisers for record keeping. Since business funds are commonly pooled together and become mixed before actual application, earmarking the source of funds (i.e. moneys) is an artificial, difficult and onerous process and subject to manipulation. Furthermore, exemption by reference to the residency of the entities rather than the source of funds (i.e. moneys) is also in line with international practice. In the situations quoted, i.e., where a foreign investor (i.e. Hong Kong resident) invests in a PRC enterprise which in turn carries out securities trading transactions in Hong Kong, and where a Hong Kong listed company centrally managed and controlled in Hong Kong (i.e. Hong Kong resident) owns a PRC enterprise which carries out securities trading transactions in Hong Kong, they are no

[10] Association of Chartered Certified Accountants (Hong Kong)

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	would, in any event, run counter to the objective of the proposed legislation to reinforce Hong Kong as a user-friendly financial centre in the world.		different from the situation where a Hong Kong resident carries out securities trading transactions through a non-resident person. The Hong Kong residents in the examples above (i.e., the foreign investor and the Hong Kong listed company respectively) should be caught by the deeming provisions. That said, it should be noted that they would only be caught by the deeming provisions if their holding of shares in the PRC enterprise exceed the threshold laid down in the Bill AND all the beneficial interests in the PRC enterprise are not bona fide widely held.
3.2	◆ The concern on the application of the deeming provisions to individuals generally has not been addressed.	HKICPA	◆ Insofar as a resident individual who carries out share transactions in Hong Kong in his own name is concerned, there is no difference in his tax position before and after enactment of the Bill. Before the enactment of the Bill, a resident individual is not chargeable to tax in respect of profits from share transactions carried out in his own name insofar as those transactions do not amount to the carrying on of a business. After the enactment of the Bill, the same tax position remains. Further, the Deeming Provisions would not apply to the resident individual who continues to carry out in his own name share transactions which do not amount to the carrying on of a business. The Administration considers that there is little justification for giving the preferential tax treatment to individuals. Beneficial interests in corporations are ultimately held by individuals. A different tax treatment for individuals would create tax-avoidance opportunity.

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3.3	◆ The concern on the issue of double taxation resulting from the deeming provisions has not been addressed.	HKICPA	◆ Double taxation generally refers to the situation where the same profit is taxed twice in the hands of the same person. This should not arise in the scenario highlighted. Where a person holds shares in, say, a Hong Kong listed company and makes a profit from the sale of the shares, he would pay tax on the profit only if the profit is revenue in nature (i.e. the profits are derived from a trade or business rather than investment). The listed company would separately pay tax on any share dealing profit it derives. The listed company's share dealing profit is distinctly different from the profit derived by the person from the sale of the shares in the listed company. No double taxation should arise. Where the Deeming Provisions apply to a resident person, the resident person would pay tax on a portion of the share dealing profits earned by the offshore fund. This is the tax that should have been paid by the offshore fund but for the exemption and also is distinct from the tax, if any, charged on the profits derived by the resident person from the sale of units in the offshore fund. Similarly, there is no double taxation. Further, Hong Kong does not tax dividends and capital gains. The profit derived from the sale of units in an offshore fund is not taxable if the units are held for investment purposes.
3.4	◆ The concern on the inability of a resident investor to claim a "deemed loss" that may be set off against other taxable profits has not been addressed.	HKICPA	◆ If an offshore fund is not exempt in any particular year of assessment, the loss it sustains in that year will be available for set off against its taxable profits in any subsequent years of assessment. As such, a non-exempt offshore fund is treated in the same way as any other business in Hong Kong. The Deeming Provisions, together with disallowing deemed loss, are intended disincentives to

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			resident persons from carrying out round-tripping. In respect of the deductibility of expenses incurred by a resident investor in generating the deemed profits, the Administration considers that no such deduction should be allowed. The expenses incurred by the offshore fund in earning the securities trading profits derived from Hong Kong would have been deducted in ascertaining the deemed profits to be imposed on the resident investor.
4	***Retrospective application of the Bill (proposed section 20AC(1))***		
4.1	◆ The proposed retrospective application of the exemption is of the utmost importance.	Joint submission	◆ The supportive view is welcomed.
4.2	◆ Uncertain whether LegCo have the authority to pass the retrospective exemption legislation, even though it is meant to be a relief or exemption, as it would have effect from a time prior to the Handover.	BCC	◆ Under section 7 of the Hong Kong Reunification Ordinance (Cap 2601), it is provided that the laws previously in force in Hong Kong, that is the common law, rules of equity, Ordinances, subsidiary legislation and customary law, which have been adopted as the laws of the HKSAR, shall continue to apply. It follows that what could lawfully be done prior to the handover can likewise lawfully be done after the handover. Before the handover, retrospective legislation may be passed without any limitation as to date of its commencement. After the handover, retrospective legislation should likewise not be subject to any restraint in this respect. Hence, the involvement of a time prior to 1997 in any amendment should not pose any problem.

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4.3	◆ Particularly concerned that the IRD may issue back Profits Tax Assessments on the boutique funds and hedge funds which did not comply with the new laws, and where the IRD has detailed information on hand about those funds. If the IRD raises substantial numbers of such back Profits Tax assessments on such Funds, damage will still be done to the perception of the tax system here being fair and certain; especially in the eyes of offshore investors. Especially as these funds have probably not accrued for such Profits Tax charges in their accounts, over the years, and could not have known that the laws would be drafted and implemented this way nearly ten years later on. ◆ We think if there is action to raise assessments based on this new legislation, the IRD should proceed with discretion. The IRD had shown discretion so far in not assessing the larger Funds since 1996.	BCC	◆ All along, any fund which derives securities dealing profits from Hong Kong is chargeable to profits tax in Hong Kong. It is the responsibilities of any fund which had profits tax liabilities to report these to the IRD as and when they arose. ◆ The proposed retrospective provisions do not impose a new tax obligation on the funds. For those funds that satisfy the exemption criteria, these provisions would exempt them from tax liabilities retrospectively; for others that do not satisfy the exemption criteria, no new tax liability would be created but they would continue to be subject to the law hitherto applicable to them, i.e. they would continue to be liable to tax. ◆ The IRD has the statutory duty to recover tax from any persons who are liable to pay tax under the provisions of the Inland Revenue Ordinance (Cap. 112) (IRO). The legal advice obtained is that IRD has no discretion to waive or forgo enforcement of the provisions of the IRO in respect of any charge to profits tax for which any entity in Hong Kong is liable. In the past, the IRD has practical difficulties to obtain information on share transactions carried out by non-residents.
5	***Schedule 16 – specified transactions***		

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5.1	◆ The definition of "securities" excludes "shares or debentures of… a private company within the meaning of section 29 of the Companies Ordinance (Cap. 32)". Some non-resident are private equity funds, providing start-up capital to certain up-coming and promising business ventures, and subsequently realizing their capital investments when the ventures concerned are mature enough. We believe that these private equity funds' activities are important to Hong Kong as an international financial centre and, therefore, the scope of the proposed exemption should also cover these activities. As such, we submit that the definition of "securities" in this context should not categorically exclude all shares or debentures of a private company within the meaning of section 29 of the Companies Ordinance. ◆ Instead, if it is the Administration's concern that shareholdings in certain types of private companies are susceptible to abuse (such as shareholdings in a private property-holding company), then those types of private companies could be specifically carved out and excluded from the definition of "securities". ◆ In any case we also consider that the current definition of "securities" is not an effective means of addressing the Administration's concern that special-purpose private companies could be used by non-resident funds to effectively trade in any types of assets in Hong Kong. This is because under the current definition of "securities", only those shares in private companies that are incorporated in Hong Kong	TIHK[11]	◆ The current policy objective of the Bill is to provide profits tax exemption for offshore funds. Tax exemption for private equity funds is not within the objective and is a separate issue. ◆ A private company may be used as a vehicle to trade in all kinds of assets. It purchases the assets and instead of disposing of them at a profit (which would be subject to tax), the shares in the company are disposed of. Where an offshore fund acquires shares in such a private company and later disposes of them at a higher price, the resulting profit would be exempted under the Bill. Thus, an offshore fund would be able to trade in all types of assets in Hong Kong through a private company free from tax. This is not the intention of the proposed legislation. ◆ The above illustrates that the problem does not only lie in property-holding private companies; it lies in private companies holding all kinds of assets. Therefore, it is not possible to define and carve out just those "private companies susceptible to abuse". ◆ We agree that it is preferable to exclude private companies incorporated in a foreign jurisdiction as well. However, it is extremely difficult to define what is a private company in accordance with the laws of *each* overseas jurisdiction which is similar to a private company under section 29 of our Companies Ordinance. These laws are numerous and potentially divergent. Besides, such

[11] Taxation Institute of Hong Kong

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	under the Companies Ordinance would be excluded. That means non-resident funds could easily circumvent the proposed legislation by using a special-purpose private company incorporated in a foreign jurisdiction, e.g. a BVI incorporated company to trade in any types of assets in Hong Kong through transfer of shares in such foreign incorporated private company.		amendments would greatly complicate the IRO. IRD would closely monitor the situation and in case of abuse in this respect, IRD would try to invoke the general anti-avoidance provisions; and if necessary, we would consider to amend Schedule 16 to exclude overseas private companies.
5.2	◆ The concern on the exclusion of shares in private companies (incorporated in Hong Kong) from the scope of the term "securities" and so from the scope of the exemption has not been addressed.	HKICPA	◆ See 5.1 above.
6	***Other comments***		
	◆ The practical problems of applying the residency test of central management and control, which should preferably be clarified by way of legislative provisions, have not been addressed.	HKICPA	◆ The "central management and control" test is a well-established common law principle adopted in many jurisdictions in determining the residency of non-individual entities. The location where central management and control is exercised is wholly a question of fact and each case must be decided on its own facts. There is a considerable body of case law on this subject to guide its operation. It is well established that the central management and control refers to the highest level of control of a business. Hence, it is not necessary and may not be possible or appropriate to set out exhaustively in the Bill the circumstances under which the central management and control of an entity is regarded as being exercised in Hong Kong. Indeed, jurisdictions (such as Australia, the UK and Singapore) that adopt the same

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			concept for determining the residency for tax purposes also do not define the scope of the concept in their statutes. The IRD will issue a DIPN to explain how the provisions of the Bill are to be applied, including the "central management and control" test with worked examples. In preparing the DIPN, the IRD will take overseas tax cases and practices into account.
	◆ More generally, we should have liked to see more support being given to the development of local boutique funds through this legislation.	HKICPA	◆ The current proposal reflects the policy of attracting foreign capital from non-residents to invest in Hong Kong's financial market by allowing tax exemption to non-residents in respect of securities trading profits. Allowing tax incentive to the fund management industry in Hong Kong per se is a matter separate from and not contemplated by the current proposal.

Treasury Branch
Financial Services and the Treasury Bureau
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