Growing Asia's Markets

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Clerk to Bills Committee on Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong

Email: bc_06_18@legco.gov.hk

Dear Sir/Madam,

ASIFMA AMG Comments on Proposed Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018

On behalf of the Asset Management Group ("**AAMG**") of Asia Securities Industry & Financial Markets Association ("**ASIFMA**"), we would like to submit for your consideration our comments on the Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018 (the "**Bill**").

ASIFMA is an independent Asia-wide industry association which focuses on capital markets development. It is part of a global alliance of similar industry associations in the U.S. and Europe. AAMG was launched by ASIFMA as a separate division in 2014 to represent asset managers. AAMG currently has 26 asset manager members, almost all of which are global asset managers with a headquarter or subsidiaries in Asia. AAMG members manage over USD 33.5 trillion in assets globally, among them numerous investment funds and institutional mandates that invest in the Asia Pacific region.

AAMG has provided on 4 May 2018 (see attached submission) our comments to the Financial Services and the Treasury Bureau ("**FSTB**") on their public consultation on their Proposals to Remove Ring-Fencing Features from the Tax Regimes for Funds, most of which were not addressed or reflected in the Bill. In particular, we would like to draw your attention to our comments on points A, B, C, E and F in the attached submission made by us to FSTB on 4 May 2018, which we would like the Bill Committee to consider.

If you have any questions regarding any of our comments, please contact Eugenie Shen at eshen@asifma.org or Tel: 2531 6570.

Yours sincerely,

Eugenie Shen

Eugenie Shen
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Attachment

4 May 2018

Financial Services Branch
Financial Services and the Treasury Bureau
Hong Kong Government
Attn: Ms. Renita Au/Ms. Carrie Chang

Email: renitaau@fstb.gov.hk/carriechang@fstb.gov.hk

Dear Sir/Madam,

ASIFMA AMG Submission on FSTB Proposals to Remove Ring-Fencing Features from the Tax Regimes for Funds

On behalf of the Asset Management Group ("**AAMG**") of Asia Securities Industry & Financial Markets Association ("**ASIFMA**")[1], we would like to submit for your consideration our views on the *Proposals to Remove Ring-Fencing Features from the Tax Regimes for Funds* issued by the Financial Services Branch of the Financial Services and the Treasury Bureau (the "**Proposals**") on 4 April 2018.

AAMG is a separate and independent division of ASIFMA made up of 23 of the largest global asset managers in the world, a list of which can be found on ASIFMA website. Between them, our members manage over USD 25 trillion in AUM globally and thousands of investment funds as well as numerous separate institutional mandates with allocations to Asia Pacific.
AAMG understands the need for the Hong Kong Government (the "**Government**") to remove the ring-fencing measures under the existing tax regimes for offshore funds and offshore private equity funds which provide tax exemption to such funds only if they do not carry on any business in Hong Kong other than specified transactions and incidental transactions. We also appreciate the Government's desire to minimise disruption to the fund industry and preserve as much as possible the pre-existing tax exemption treatment for funds already operative in Hong Kong.

A. Proposed change from "non-resident person" to "fund"

However, we have serious concerns with the proposal in paragraph 7 of the Proposals to change the beneficiary of the profits tax exemption from "non-resident person" to "fund" using the definition of "collective investment scheme" in Schedule 1 of the Securities and Futures Ordinance ("**SFO**") albeit

[1] ASIFMA is an independent, regional trade association with over 100 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, professional and consulting firms, and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative and competitive Asian capital markets that are necessary to support the region's economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the United States and AFME in Europe, ASIFMA also provides insights on global best practice and standards to benefit the region.

with suitable modifications. This is because often an asset manager may set up a private fund for a single investor, which may not fall within the definition of a "collective investment scheme" or which may not be viewed as a pooled investment arrangement.

Similarly, we note that the current tax exemption for "non-resident person" is enjoyed not only by funds but other non-resident institutional and individual professional investors for whom Hong Kong asset managers provide discretionary investment management services. Under the current Hong Kong tax regime, if these non-resident investors invest directly in Hong Kong securities, they would not be subject to Hong Kong profits tax if they do not carry on any business in Hong Kong. In view of the past efforts exerted by the Government to promote Hong Kong's asset management business, it is imperative to preserve the current profits tax exemption status for the aforementioned non-resident investors that are investing in Hong Kong securities through Hong Kong asset/investment managers.

We also note that the current legislation is in line with that of a number of other members of the OECD which would not tax "non-resident persons" whose only connection with their country is giving a discretionary investment management mandate to a local investment manager. To take the United States ("U.S.") as an example, there is a specific exemption for a foreigner who trades U.S. and non-U.S. securities either directly or through an agent (such as a U.S. investment manager) from being treated as having a U.S. trade or business or taxable presence in the U.S.

We note further that the OECD's own Income and Capital Model Convention (2017) provides for tax exemption for foreigners using local agents from local tax in that an enterprise shall not be deemed to have a permanent establishment and hence a taxable presence in a state merely because it carries on business in that state through an independent agent operating in the ordinary course of its business (Paragraph 6 of Article 5).

Therefore, we strongly urge the Government <u>not</u> to limit the application of the profits tax exemption to a "fund" or "collective investment scheme" as defined in Schedule 1 of the SFO as this change would significantly narrow the current beneficiaries of such exemption and hurt the asset and wealth management businesses in Hong Kong which manage the investments of many non-resident institutional investors as well as wealthy individuals. We suggest that the Government consider amending the term "non-resident person" to "person" to preserve the current tax exemption for non-resident investors, whether they are funds or institutional investors or individuals.

B. Specified person and qualifying fund requirements

In regard to the proposal in paragraph 8 of the Proposals which require the entity claiming profits tax exemption either to engage a "specified person" (i.e. licensed or authorised financial institutions under the SFO) to arrange its transactions or be a "qualifying fund" under section 20AC(6) of the Inland Revenue Ordinance ("**IRO**") to be eligible for tax exemption, we have the following comments.

Given that a non-resident person or fund may engage in transactions in Hong Kong and elsewhere, we assume that not all such transactions need to be arranged by a specified person. For example, we assume that transactions outside Hong Kong would not need to be arranged by a specified person. In addition, even if a transaction is in Hong Kong but it is undertaken by an investment manager outside Hong Kong, it also would not need to be arranged by a specified person because it is not connected with a trade or business in Hong Kong. It would be helpful if the foregoing can be clarified as you will appreciate that a fund or other investment entity may appoint different managers (e.g. one in Hong Kong and another outside Hong Kong) to manage different pools of assets. As the "specified person" condition goes to whether an entity or fund qualifies for tax exemption at all, the proposal on no tainting in paragraph 12 of the Proposals would not be a cure for the issue noted above.

We also note that the definition of "qualifying fund" under the IRO, which was introduced in the Inland Revenue (Amendment) No. 2 Ordinance 2015 to accommodate private equity funds that are typically not managed by a "specified person", is broader than the definition of "collective investment scheme" under the SFO. This is another reason why we oppose changing the beneficiary of the profits tax exemption from "non-resident person" to a "fund" by reference to a definition in the SFO as the latter may exclude some "qualifying funds".

We welcome the proposal in paragraph 9 of the Proposals not to have any fund size requirement to be eligible for tax exemption as this would help start-up funds.

C. Non-eligible assets

In regard to condition (a) in paragraph 10 of the Proposals that the entity entitled to enjoy profits tax exemption on all of its profits does not carry on any direct trading or business undertaking in "non-eligible assets", we understand that it is proposed that any assets not set out in paragraph 11 of the Proposals would be considered "non-eligible assets".

As paragraph 8 of the Proposals does not make it clear whether there is any geographical limitation on the "non-eligible asset" condition, we suggest that the non-eligible asset test makes it clear that the entity or fund enjoys profit tax exemption even if the non-eligible assets are held outside Hong Kong or if the non-eligible assets are held in Hong Kong they are not connected with a Hong Kong trade or business. As the "non-eligible asset" condition goes to whether an entity or fund qualifies for the tax exemption at all, any geographical overreach in the "non-eligible asset" condition is not cured by removal of the tainting proposal in paragraph 12 of the Proposals.

Among the "eligible assets" set out in paragraph 11 of the Proposals is "(e) bank deposits (excluding money lending)". We note that Section 2(1) of the Banking Ordinance (Cap. 155) defines "deposit" as "(a) a loan of money (i) at interest, at no interest or at negative interest; or (ii) repayable at a premium or repayable with any consideration in money or money's worth but (b) does not include . . . . .". We note further that the existing profits tax exemption available to non-resident funds pursuant to Section 20AC of the IRO extends to transactions consisting of the making of a "deposit (other than by way of a money-lending business)" where "deposit" is defined in Part 2 of Schedule 16 of the IRO as "a loan of money (i) at interest; or (ii) repayable at a premium or repayable with any consideration in money or money's worth".

We suggest that for purposes of paragraph 11 of the Proposals, item (e) thereof be amended to simply refer to "deposits" as an eligible asset class so as to be consistent with the existing scope of exemption under Section 20AC of the IRO. Money lending, which is excluded from the "bank deposits" asset class in paragraph 11 of the Proposals is not an asset class per se. It would be helpful to clarify what constitutes "money-lending" so as to establish the circumstances under which the making of "deposits" would not qualify as a specified transaction. For example, would a fund that invests in private credits and/or loans be able to enjoy the profits tax exemption?

D. Conditions for investments in private companies

We understand paragraph 12 of the Proposals is intended to put in place measures to reduce the risk of tax evasion by structuring a trading assets transaction through a fund's sale of a private company holding such assets. However, it is not entirely clear how sub-paragraphs (a), (b) and (c) inter-relate with each other or if they are to be treated independent of each other. Set out below are our understanding and suggestions on the wording of these conditions:

1. If sub-paragraph (a) is intended to apply to all private companies that a fund holds, then we suggest that sub-paragraph (a) be simplified to read as follows:

   "such private companies do not hold, in aggregate (whether directly or indirectly), more than 10% of their assets in immoveable property in Hong Kong; or"

   We note that the holding threshold of 10% of assets in immoveable property for treating investments in a company as indirect investment in real property is much lower than the threshold of 50% of assets used in most treaty capital gains provisions and in the Australian Taxable Property provisions. Therefore, we suggest that the Government consider increasing the 10% threshold to a higher percentage up to 50% for purposes of this sub-paragraphs (a) and sub-paragraph (b) below.

2. Where sub-paragraph (a) is not met, then sub-paragraph (b) could apply and if so, we suggest that sub-paragraph (b) be simplified to read as follows:

   "the fund has held private companies holding, in aggregate (whether directly or indirectly), more than 10% of their assets in immoveable property in Hong Kong, for at least [see suggestion below] years; or"

   For sub-paragraph (b), we are of the view that the proposed five-year holding period required to qualify for tax exemption is too onerous, particularly compared with the holding period adopted by other jurisdictions (e.g. two years in Singapore and one year in India for capital/revenue or long-term/short-term income distinction). To enhance the attractiveness of Hong Kong's tax exemption regime, we suggest that the holding period for immoveable property be shortened to two (2) years or even one (1) year. If this is viewed to be too short a period, then three (3) years is more than sufficient as this would be consistent with the holding period for distinguishing short-term assets from long term assets.

3. Where neither the conditions in sub-paragraph (a) nor sub-paragraph (b) are met, then sub-paragraph (c) could be available and if so, we suggest that sub-paragraph (c) be simplified to read as follows:

   "each such private company does not hold more than 50% of its assets in short-term assets (as defined in section 20AH(12) of the Inland Revenue (Amendment) (No. 2) Ordinance 2018)."

Please clarify if our understanding is incorrect.

E. Removal of Tainting and Treatment of Incidental Transactions

We welcome the Government's proposal in paragraph 13 of the Proposals to remove any "tainting" of a fund even if the conditions in paragraph 12(a), (b) or (c) of the Proposals are not met.

While we appreciate the proposal in footnote 9 in paragraph 13 of the Proposals to maintain the current tax treatment of incidental transactions, we strongly urge the Government to reconsider DIPN No. 43's interpretation of "incidental transaction" to remove the reference to "receipts of interest . . . . on securities" since coupon interest on bonds clearly forms part of the regular return/income anticipated by fixed income investors and is factored in the market price. Interest income from debt securities should be distinguished from dividends on securities, which may or may not be payable depending on the performance and dividend policy of the issuers of the securities and hence is the reason why dividends are considered “incidental transactions”. Clarifying that receipt of interest from debt securities would not be viewed as an “incidental transaction” but as a specified transaction will greatly enhance the development of Hong Kong’s bond market, especially with the launch of the Bond Connect last July.

F. Deeming Provisions

We understand that the purpose of the deeming provisions mentioned in paragraph 14 of the Proposals is to reduce the risk of tax leakage and disincentivize resident persons from taking advantage of the tax exemption. This purpose seems anomalous given that (1) the purpose of the Proposals is to remove measures that isolate certain practices from the local economy and (2) the harsh and arbitrary impact of the deeming provisions may cause resident investors to invest in offshore products or engage offshore investment managers.

We suggest that the deeming provisions be replaced by better targeted measures that only bite if the resident investor’s tax treatment is materially changed by investing via a fund. For example, Hong Kong life insurers taxed on a percentage of premiums may be subject to the deeming provisions if they hold a significant stake in a fund managed by a Hong Kong investment manager. This may lead them to look to outsource their investment management to non-Hong Kong investment managers particularly if an insurance group is pooling investments from a number of jurisdictions to be invested in a common strategy through a fund or corporate structure. We believe such outcome would be contrary to the Government’s desire to promote and develop Hong Kong’s asset management business.

We thank the FSTB for giving us an opportunity to comment on the Proposals and hope that you will find our suggestions helpful. We look forward to the final changes to the IRO with many of our suggestions adopted. If you have any questions regarding any of our comments, please contact Eugenie Shen at eshen@asifma.org or Tel: 2531 6570.

Yours sincerely,

Eugenie Shen

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