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

24 October 2005

By fax (2537 1851) and by post

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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.

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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
Director, Specialist Practices

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c.c. Secretary for Financial Services and the Treasury (Attn: Mr. Ivanhoe Chang)
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