THE LAW SOCIETY OF HONG KONG
香港律師會

COMMENTS BY THE SECURITIES LAW COMMITTEE

Consultation Paper On Exemption Of Offshore Funds From Profits Tax

The consultation paper on exemption of offshore funds from profits tax ("Paper") puts forward a proposal ("Proposal") to exempt offshore funds from profits tax under the Inland Revenue Ordinance ("IRO"). The stated objective of the proposal is "to reinforce the status of Hong Kong as an international centre by increasing its attractiveness to offshore fund managers".

The Committee is very strongly of the view that the Proposal will not achieve its stated objective and will be materially detrimental to both Hong Kong's existing funds management industry and the future development of that industry.

The Committee's specific concerns are set out below.

Summary of concerns

The Committee is of the view that the Proposal:

(i) fails to understand certain critical aspects of the funds management industry both in Hong Kong and globally;

(ii) ignores a fundamental distinction between investors in funds who invest as part of a taxable business activity and investors whose investments do not form part of a taxable business activity;

(iii) is inequitable in that it will (effectively) impose a tax burden on investors who would not otherwise be subject to Hong Kong profits tax on their investments;

(iv) is inequitable in that it may impose double taxation on some investors;

(v) will create high levels of uncertainty amongst investors and fund managers alike - such uncertainty is likely to be a significant obstacle to both the establishment of new funds management businesses in Hong Kong and the raising of capital from both onshore and offshore investors;

(vi) is inequitable because, at a technical level, it has the potential to change a fund's taxation position without any act or omission on the part of the fund manager or the managements of the fund's investors;

(vii) will place Hong Kong at a significant competitive disadvantage to other jurisdictions seeking to establish and/or promote a funds management industry (e.g. Singapore, UK);

(viii) represents a fundamental departure from one of the principles of Hong Kong taxation - that it is source of profits and not residence that is the primary determinant of liability for Hong Kong profits tax;

(ix) is technically difficult to administer and enforce and will impose undue hardship and burdensome compliance obligations on fund managers;

(x) given the above it is difficult to see how the Proposal will achieve any fiscal objective.

Each of these is addressed in more detail below:-

1. Nature of the funds management industry

The Proposal is concerned with funds which are not authorised for offer to the public in Hong Kong (funds authorised for offer to the public in Hong Kong already benefit from an exemption from profits tax).

It must be recognised that the management of a non-authorised fund will typically be in the hands of a limited number of individuals and does not require large scale investment in fixed assets. Subject to regulatory licensing requirements, and given modern technology, a fund manager can carry on a funds management business from any one of a number of countries which offers adequate infrastructure, political stability, a suitable regulatory framework and a benign taxation regime. Subject to these (and possibly other criteria), fund managers have considerable flexibility in selecting and changing the jurisdiction from which they wish to carry on business. Put simply, a fund management business is a highly mobile one that can be moved relatively easily.

The Committee is concerned that, for the reasons set out below, the Proposal may encourage fund managers to elect to set up new operations outside Hong Kong and for fund managers already based in Hong Kong to consider relocating offshore.

2. Taxable and non-taxable investors

Hong Kong taxation law differentiates between investments which are made as part of a taxable business activity and investments which are not made as part of taxable business activity (e.g. an institutional investor as compared with an individual who invests in funds occasionally).

The Committee is of the view that the Proposal is inconsistent with this principle.

For example: if we consider the position of a hypothetical investor whose investments do not currently constitute part of a taxable business activity:

(i) if the investor invests directly in underlying investments, gains or losses on those investments will not be subject to Hong Kong profits tax;

(ii) under the Proposal, if the investor invests in a fund in which less than 20% of the beneficial interests are held by Hong Kong residents, gains or losses on that investment will not be subject to Hong Kong profits tax (either directly or indirectly through profits tax chargeable to the fund);

(iii) under the Proposal, if the investor invests in a fund in which 20% or more of the beneficial interests are held by Hong Kong residents, gains or losses on that investment will be effectively be taxed through profits tax chargeable to the fund.

In effect, even if (a) the tax position of the investor has not changed and (b) the underlying investments of the direct investments in scenario (i) and the indirect investments through the two funds in scenario (ii) and (iii) above are the same, the investor will end up paying Hong Kong profits tax on his/her investment solely because other investors in the fund happen to be resident in Hong Kong. These other investors may well be completely unconnected to our hypothetical investor and the fund manager.

In effect, the Proposal both ignores the tax status of investors in a fund and imposes taxation liability based on the residence of a minority of investors in the fund. The Committee is of the view that this is inequitable.

If a fund which is managed by our onshore fund manager may be subject to Hong Kong profits tax by reason of the manager of the fund carrying on the business of managing the investments of the fund from Hong Kong then investors (both onshore and offshore) will have considerable incentive to invest in funds which are <u>not</u> managed a Hong Kong resident fund manager.

3. Development of the funds management industry

The Committee is strongly of the view that the Proposals will be a material obstacle to the establishment of both new start-up fund management companies in Hong Kong and offices of multinational fund managers.

Consider the position of a start-up fund managers. If a start-up fund manager wishes to establish its operations in Hong Kong it will seek to raise investment capital for its first fund.

Typically Hong Kong domiciled investors (high-net investors individuals, institutions and others), will be selectively targetted as the initial or "seed" investors in the new fund. This typically results in a significant proportion of the investment funds initially raised coming from Hong Kong resident investors. Although the Committee does not have any empirical data on point, it would be reasonable to assume that a significant number of new fund management start ups based in Hong Kong would begin operating with a fund in which considerably more than 20 per cent. of the beneficial interests will held by Hong Kong resident investors.

The Committee is of the view that the Proposal will be an significant obstacle to start ups seeking to raise investment capital in Hong Kong.

All other considerations being equal, Hong Kong domiciled investors will invest in funds managed offshore which are not subject to taxation in preference to funds managed onshore which are or may be subject to Hong Kong profit tax.

Start-up fund managers will be fully aware of this and react accordingly - most likely by selecting another jurisdiction in which to establish their business.

Similar considerations will apply to other fund managers:

- both existing multinational fund managers (either having an existing presence in Hong Kong or considering establishing such a presence);

- existing domestic fund managers.

4. Double taxation

The Committee is of the view that the Proposal raises the possibility of an investor being subject to double taxation.

Consider the position of an investor in a fund where the investor's investment is part of a business activity which is subject to Hong Kong profits tax and where, under the Proposal, the fund is also subject to Hong Kong profits tax.

In this situation, the investor will effectively pay tax twice:

(i) indirectly through the tax paid by the fund; and

(ii) directly on the profits made on his investment.

The Committee is of the view that double taxation would provide considerable incentive for investors whose investments are part of a business subject to Hong Kong profits tax to shift investments away from funds managed by Hong Kong resident fund managers and towards funds managed by fund managers resident in other jurisdictions.

5. Uncertainty - for investors

The Committee is of the view that the Proposal would create considerable uncertainty among investors. More specifically:

(i) potential investors will not know at the time they are asked to invest whether the fund they invest in will be subject to Hong Kong profits tax or not - they will only find out after all the beneficial interests have been issued;

(ii) many funds are open ended. It is possible that subscription by new investors or redemption by existing investors will change the ratio of Hong Kong resident investors to non-Hong Kong resident investors in such a way as to change the tax status of a fund; and

(iii) for both open end and closed end funds, it is possible that a change in domicile of a single investor in a fund could result in the tax status of a fund changing.

Investors do not like uncertainty. Investors do not like risk (in this case the risk that returns will be reduced by unanticipated taxation). The Committee is of the view that the uncertainties created by the Proposal (and the resulting risk) will be a considerable disincentive to investors electing to invest in a fund managed by a Hong Kong resident manager in comparison to a similar fund managed by a manger resident in a jurisdiction the laws of which do not create such uncertainty.

6. Uncertainty - for fund managers

Fund managers will perform due diligence on potential investors before accepting them (e.g. for money laundering purposes). It would be unusual for such due diligence to include an investigation of a potential investor's tax status in any particular jurisdiction. As a practical matter it is possible that any such investigation would be heavily dependant on representations made by the investor which would be difficult to independently verify. For present purposes, under the Proposal fund managers may wish to verify that a potential investor is not a Hong Kong resident. This would be a very difficult thing to establish (it is effectively asking the fund manager to prove a negative). The Committee is of the view that fund managers may face considerable uncertainty in establishing that an investor is not resident in Hong Kong.

In addition, an investor's place(s) of residence may change. As a practical matter, fund managers will be heavily reliant on undertakings from investors to notify them of their change in residence. If a change in residence of an investor will result in a change in the tax status of the fund, then the investor obviously has an incentive not to inform the fund manager.

As a separate point, fund managers will need to disclose information about the fund's tax position to prospective investors - given the uncertainties described above, the fund manager will not be able to make definitive statements on point.

The Committee has considered the possibility that fund managers could elect to limit offerings to either offshore investors only or to a mix of onshore and offshore investors which satisfies the requirements of the Proposal's anti-avoidance provisions. The Committee is of the view that such an approach addresses none of the concerns raised elsewhere in this paper and, further, is commercially unattractive.

7. Grace period

The Committee has considered the possibility that the concerns raised elsewhere in this paper could be addressed by allowing for a grace period to apply - effectively a period between the anti-avoidance provisions being triggered and the change in tax status taking effect to allow investors (and the fund manager) to remedy the situation either by investors exiting the fund voluntarily or by the fund manager exercising a power of compulsory redemption against selected investors in order to preserve the tax-exempt status of the fund.

The Committee does not consider that such proposal will be address the concerns raised in this paper - in particular those relating to the initial subscription for fund interests. In addition, such a proposal raises the possibility of instability in the fund's investor base as many, if not most, investors may well elect to take the safe option and redeem their interests as soon as they become aware of the potential for a change in the tax status of the fund.

8. Comparative disadvantage compared to other jurisdictions

The Committee is of the view that the Proposal is different from the approaches taken in other leading jurisdictions (e.g. Singapore, UK) and, on a comparative basis, is less favourable to the development of the funds management industry.

9. Anti-avoidance

The Committee recognises that tax avoidance is undesirable and that appropriate anti-avoidance legislation is desirable as a matter of sound fiscal policy.

However, the Committee is also of the view that, in relation to managed funds, anti-avoidance legislation should be primarily be aimed at investors who are seeking to avoid tax rather that either the fund (with risk to investors who are not trying to avoid tax) or the fund manager.

10. Fiscal Objective

The Committee is of the view that the concerns raised in this paper would indicate that any fiscal objective underlying the Proposal is unlikely to be achieved.

Alternative proposals

The Committee is of the view that if the Hong Kong SAR Government wishes to promote Hong Kong as an international centre for funds management, then a taxation regime which is at least as favourable as competing jurisdictions should be adopted. The current Proposal not only fails to achieve this objective, but will, if adopted, place Hong Kong at a competitive disadvantage compared to other international financial centres.

Alternative approaches which could be considered may include:

(i) Simplifying the 20AA rules through which one must first pass to even consider the new proposal under S20AB. Such proposals would include the removal of the associate and independence tests currently required to be met under S20AA.

(ii) Changing the test completely to follow, for example, UK rules where there are a number of conditions for the exemption to apply which are designed to ensure that the manager is acting in an independent capacity: e.g. no more than 20% of the fund may be held by connected persons averaged over a 5 year period and the manager must receive a fully arms length fee. In addition there is no requirement based on the percentage UK resident ownership of the fund. There are requirements that the board is majority non UK resident, meets offshore and is the governing body of the fund, but these are core to residence based on central management and control concepts (which do not apply in Hong Kong in any event).

(iii) If the existing S20AB test is to remain then changing the % threshold of resident / non-resident investors to say 51% / 49%.

(iv) Allowing an averaging period to determine whether a fund is taxable for any one year should the 80:20 threshold be breached.

(v) Allowing grace periods for new start up funds / fund managers not to comply with the requirements; be that of S20AA or S20AB.

The Committee has not considered the merits of any of the above alternative approaches, and expresses no views on their merits. If any of these alternative proposals is to be considered further the Committee recommends that this is to be done through a follow on consultation exercise.

Technical aspects of the Proposal

The Committee has not addressed any technical issues arising from the drafting of the proposed amendments to the IRO.

The Law Society of Hong Kong
Securities Law Committee
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