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Onshoring the Offshored

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What is “onshoring”?

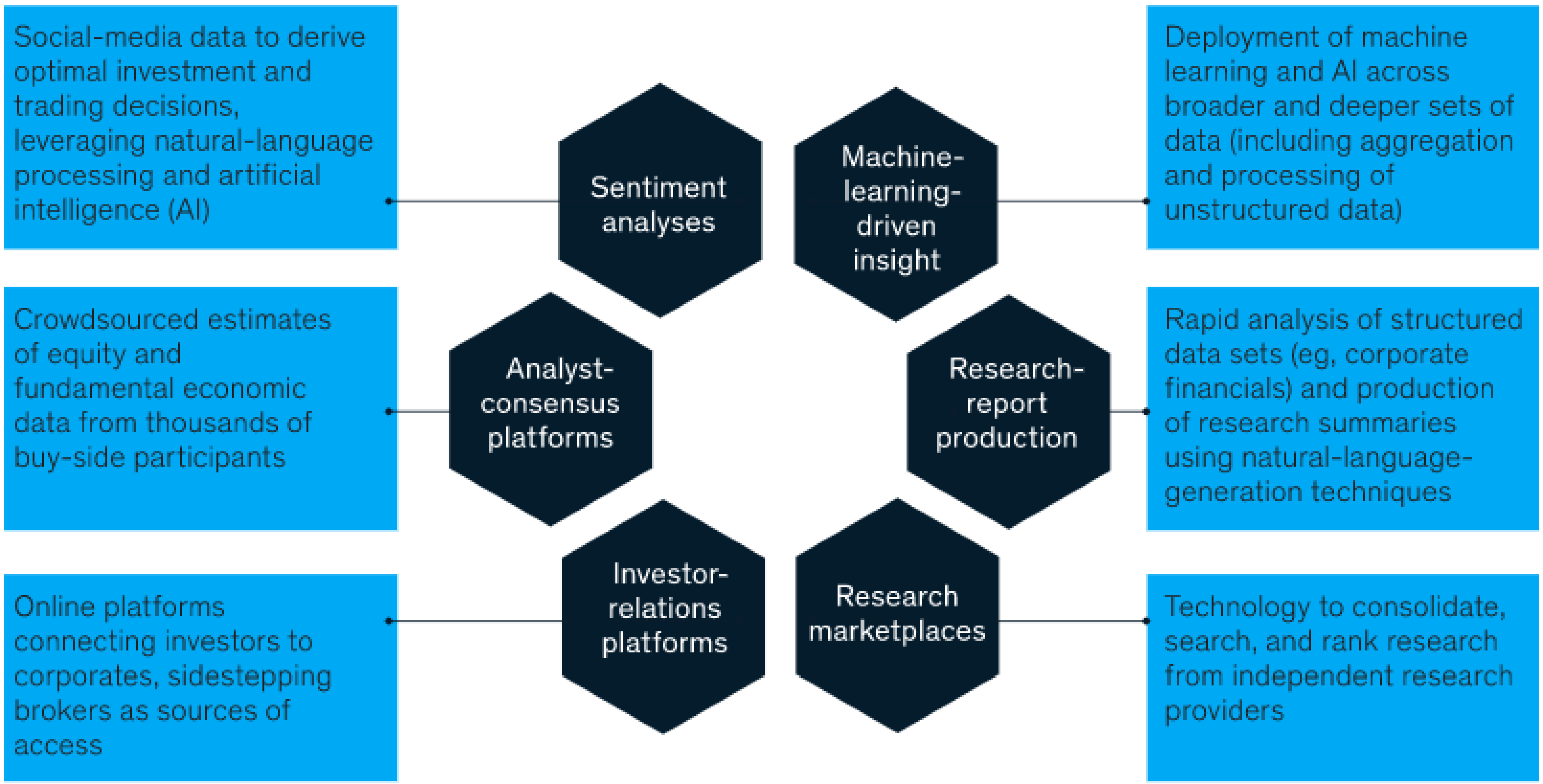
- **Offshoring** is the relocation of a whole process, piece of a process, a function, or a discrete piece of work outside the boundaries of the United States, either within or outside the boundaries of the company.
- This means work performed either as an affiliate or work "outsourced" to another firm (known as outsourcing).
- **Onshoring** frequently refers to an overseas investment by a domestic company (or overseas affiliate) that is subsequently reinvested back into the domestic marketplace; this is what is meant by bringing jobs back home.
- In reality, onshoring has a broader definition and is actually defined as any direct investment into the domestic marketplace by a domestic company.
- "**Nearshoring**" is a domestic company investing outside the country, but into a neighboring or "near" country. For example, nearshoring to the United States would be a U.S. investment in Mexico or Canada - part of the Americas as a whole when considering the entire world.
- "**Inshoring**" is a new term that refers to an investment by a foreign company into some other country. This is also called an inbound foreign direct investment.

Outsourcing	Offshoring	Nearshoring	Onshoring
Transfer of operational activities to external locations	Relocation of operating activities to another country	Outsourcing of business processes to nearby countries, often sharing a border	Relocation of business processes to a lower-cost location inside national borders

Background of offshoring and onshoring

- Countries were historically held back from trading by limitations of excess shipping and difficult, costly communications.
- The Internet, together with the development of highly efficient and inexpensive transportation of goods on a global basis, fueled worldwide economic growth and subsequently led to globalization.
- The transformation has been swift.
- In manufacturing, investment went from a "trade-then-invest" model to an "invest-then-trade" model. This has now become a model of "invest to optimize the value chain."
- Competition has become fierce and global, forcing survivors to seek out locations that minimize costs and maximize efficiencies. In services, offshoring allows companies to compete on a global basis for lower costs and better efficiencies for their information technology (IT), business process outsourcing (BPO), call centers, and the like.

Asset managers are turning to new sources of investment research.



McKinsey & Company

Win Win?

- Is offshoring always “win win”?
- **On the investor's end**, offshoring has enabled significant market growth and return on investment (ROI).
- **On the recipient's end**, international investment and trade have brought millions out of poverty on a global basis by creating new jobs and new markets - often at the expense of the developed countries and their own domestic jobs and market share.

Gap analysis

- The playing field is becoming global and is quickly leveling out as gaps in price and quality parities are starting to narrow.
- The third gap, that of time, is also closing as transportation and communications continue to improve. Blockchain and DFI will accelerate this trend.
- Although the parity gap is closing, **we will never reach parity**. Closing the gender gap alone expected to take 135 years by one estimate. https://www.weforum.org/reports/ab6795a1-960c-42b2-b3d5-587eccda6023
- In fact, the countries against which parity is measured may well change.
- The growing parity being witnessed today is being measured only between the world's present Tier I cities that have attracted the majority of offshore investment, a small percentage of the total global population.

“The poor will always be with you”

- Tomorrow's population will be very urban, living in new cities with new infrastructures and new competitiveness.
- Most of the population growth in the next few decades will be outside the developed countries.
- Our present world of over 6 billion people will grow to 9 billion by 2050. Sustainability becomes a dominant focus.
- 98% of these new inhabitants will be born in developing countries - with over one-half living below the poverty line of making $2 a day.
- There will always be a cheaper place to invest.

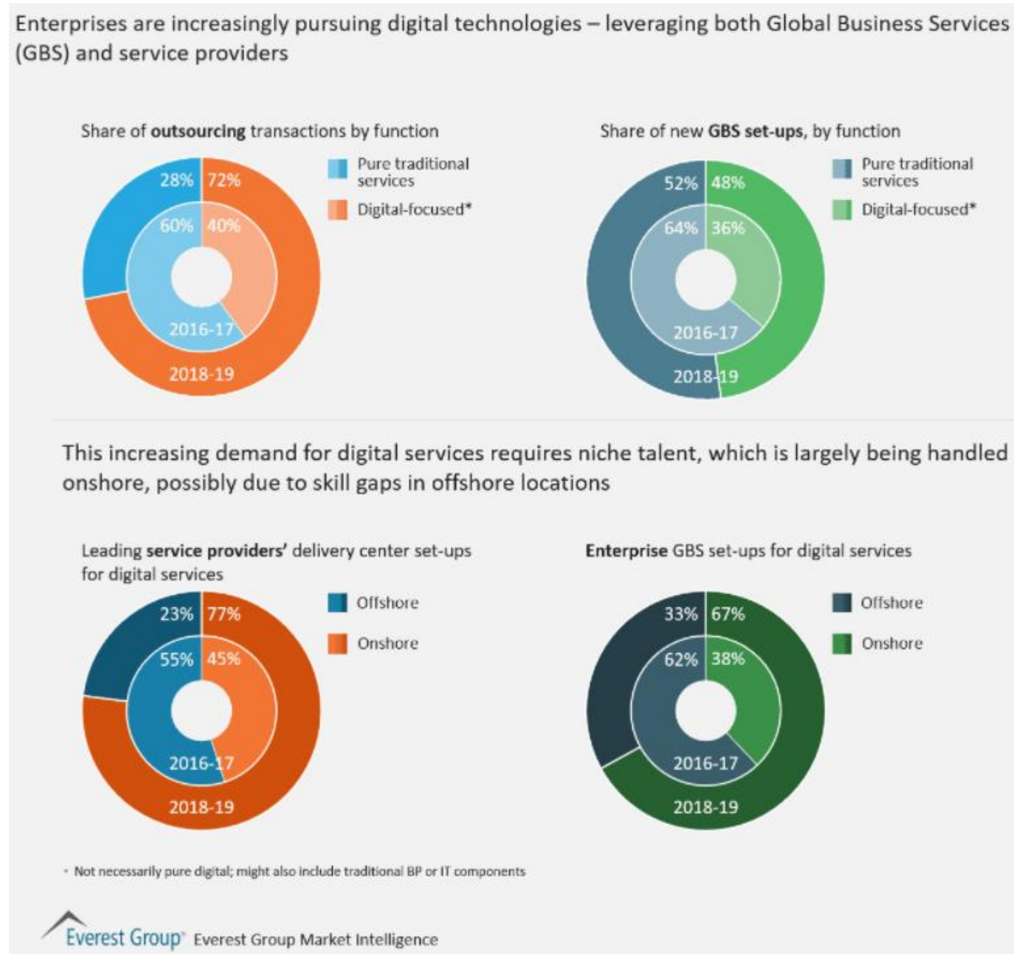
The future of manufacturing onshoring

- Absent a large, qualified manufacturing work force with globally competitive labor costs, manufacturing per se will not return to developed countries
- For example, most U.S. manufacturers considering onshoring back to the United States will most likely instead nearshore back to other North American or Central American locations to remain globally competitive.

Services onshoring

- The services sector will be better positioned for some onshoring activity.
- This is because investments in this sector are much more flexible than manufacturing.
- Overseas inflation rates, all-in labor costs, labor quality, high churn rates, high benefits costs, training costs, waste, corruption, and increasing domestic and foreign competition will all be factored in to any offshore/onshore investment decision.
- This brings us to the investment management and wealth management industries, which are service sector industries.

Rising digital demand among enterprises is driving onshoring



A short history lesson: How we got to where we are today here in Hong Kong

In 1997, the "10 commandments" were repealed. These provisions required a hedge fund managed by a U.S. based firm to perform 10 duties outside the US if they were not to be subject to certain U.S. taxes on U.S. source income. The ten commandments were:

1. Communicating with shareholders;
2. Communicating with the general public;
3. Soliciting sales of the company's stock;
4. Accepting subscriptions of new shareholders;
5. Maintaining the principal corporate records and books;
6. Auditing the company's accounts;
7. Disbursing payments of dividends, legal fees, accounting fees & directors' fees;
8. Publishing or furnishing the offering & redemption price of the company's shares;
9. Conducting shareholders' and directors' meetings;
10. Making redemptions of the company's stock.

As one commentator noted . . . .

Even readers who are not steeped in the securities business can readily see the silliness of a rule that allows the fund's brainpower and crucial trading functions to be in the United States, while deeming it to be doing business in some island jurisdiction, like Bermuda or the Caymans, where some custodian banks and local professionals keep books and hold pro forma board meetings. The old rule, of course, was a boon to tax haven bean counters, who would otherwise have to busy themselves with brass nameplate corporations and undercapitalized insurance companies.

“Off the Off” ramp

- A large proportion of alternative investment funds distributed and/or investing in Asia have traditionally been established in "offshore" jurisdictions (principally, the Cayman Islands and other tax neutral jurisdictions where the fund manager has limited substance).
- This “onshoring” of the investment funds industry is occurring principally because
  - evolving global investor preferences,
  - substance concerns from a tax perspective (including related political and public relation issues in the EU and elsewhere),
  - anti-money laundering related concerns,
  - increasing familiarity with onshore vehicle options, and
  - regulatory developments in both onshore and offshore jurisdictions
- Asset managers generally gravitate towards the most favorable structure overall, so from that perspective, true offshore domiciles (Cayman, BVI, Mauritius, etc.) are losing their arbitrage advantage and their disadvantageous features are starting to compel managers to adopt onshore structures. This has contributed to move toward Asian fund domiciles
- Asian financial centers like Hong Kong and Singapore have both added onshore vehicle options to the toolbox of available fund vehicles, and aggressively promoted the growth of the local fund and asset management industry

What fund managers (and investors) want

- Some jurisdictions are known for being attractive fund domiciles
- Others are well-known for being financial centers with a supportive ecosystem for establishing a fund management business.
- However, there are few jurisdictions that serve both functions well, and that is exactly what Asian financial centers are aiming to do.
- It is this co-location of fund manager and fund domicile (and the related ease of operation and administration, robustness of tax structuring, and increasing familiarity to international investors) that makes these onshore jurisdictions such a compelling offering for Asia-focused funds.

Recent regulatory moves—new vehicles

- Singapore introduced the Singapore limited partnership in 2009, amending its Limited Partnership Act in 2017 to be more user-friendly (i.e. adopting certain changes already adopted in Cayman, such as creating certain safe harbors for activities that definitively would not constitute LPs being involved in management of a ltd partnership).
- Hong Kong's new limited partnership fund regime came into operation on 31 August 2020. **337 LPFs now registered.**
- As the limited partnership remains the dominant vehicle of choice for private funds globally, these onshore limited partnership vehicles present a serious alternative to the traditional offshore option for Asian fund managers.
- In the last several years, Hong Kong and Singapore have also introduced variable capital corporate vehicles (e.g., the Hong Kong open-ended fund company and the Singapore variable capital company) that target use by the funds and asset management industry across a broad variety of open-ended and closed-end funds. **58 OFCs now registered.**
- With increasing adoption of these vehicles by fund managers and investors alike, these onshore options have been rapidly gaining traction in the market – a consideration that is key to any fund manager aiming to raise a successful fund product.

Recent regulatory moves—new frameworks

- Asian financial centers have been just as keen to create a straight-forward and business friendly regulatory framework for fund managers.
- For example, Singapore introduced a two-tiered licensing and registration regime for fund managers based on AUM, and rolled out a simplified licensing regime for managers of venture capital funds in recognition of their business model, investor base and in support of start-up and growth stage businesses.
- Additionally, Singapore has a real estate exemption from the requirement to be a registered or licensed fund manager and also an exemption for family offices and other corporate groups that can demonstrate they are managing only their own money (although the latter has recently been clarified/tightened to avoid the perceived abuse of individual natural persons seeking regulated status in order to achieve tax exempt status investing their own personal wealth).
- For Hong Kong, in addition to the relaxations to the Securities and Futures Commission (SFC) licensing requirements of hedge fund managers that were introduced in 2007, the SFC recently provided guidance for private equity firms seeking to be licensed by the SFC. Moreover, the SFC has offered a concession rate for the annual licensing fees payable by fund managers and their licensed individuals.

Tax safe harbors are important!

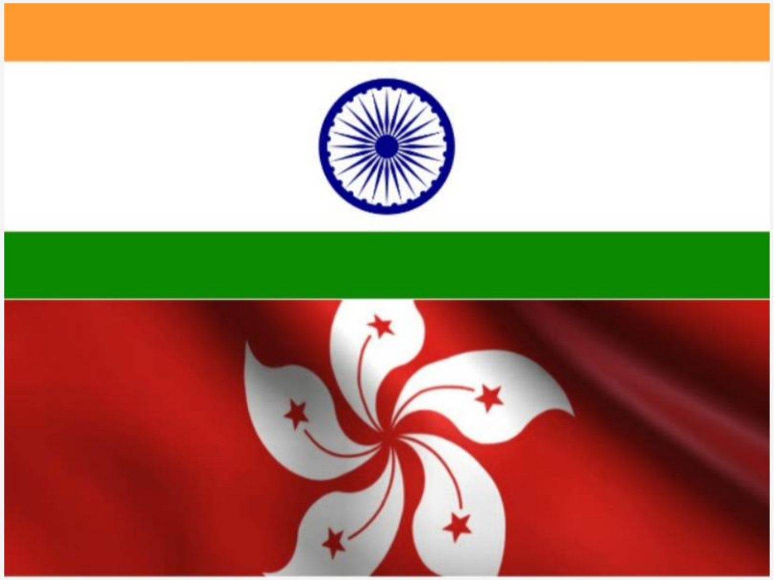
- For tax certainty and mitigation of exposure of funds managed by onshore fund managers, Singapore and Hong Kong have both also introduced safe harbors for funds managed on a discretionary basis by fund managers located in the jurisdiction.
- For example, the Resident Fund Scheme, Enhanced Tier Fund Scheme and Offshore Fund Scheme allow a wide range of specified income from an extensive list of designated investments to be exempt from Singapore tax.
- Furthermore, Singapore fund managers that qualify for the Financial Sector Incentive for Fund Managers also enjoy a concessionary corporate tax rate for fund management and investment advisory services.
- The regulated managers concessionary rate in Singapore reduces an already attractive 20% corporate rate (at least relative to marginal tax rates in other global “onshore” financial hubs) to 10%, although note the point above re moves to tighten the rules to ensure reduced tax rates and exemptions reserved for “true” asset managers. These moves seem likely to expand and become more complex as more managers arrive/expand in Singapore and try and explore unintended loopholes in what has been, to date, a relatively straightforward regime linking regulated status and tax concessions/exemptions.
- Similarly, Hong Kong has exempted qualifying assessable profits of non-resident "offshore" funds from Hong Kong profits tax since 2006. Beginning April 2019, a new "unified funds tax exemption" regime came into effect in Hong Kong which, subject to qualifying conditions being met, provides funds, regardless of their tax residency, exemption from Hong Kong profits tax on their assessable profits arising from qualifying transactions as well as transactions incidental thereto.

Unified Tax Exemption

- Besides expanding the scope of funds eligible for tax exemption, the new Hong Kong unified funds tax exemption regime also removes certain problematic features under the offshore funds tax exemption regime and expands the scope of qualifying investments.
- These improvements provide greater flexibility and more certainty to fund managers seeking to "onshore" their funds in Hong Kong.
- In addition, the Hong Kong government is providing a tax concession for carried interest. Clarity on the tax treatment of carried interest, together with tax relief, have been warmly welcomed by the funds industry.
- Efforts by both Singapore and Hong Kong to introduce tax incentives and provide clarity of tax treatment have been a key part of their efforts to become attractive fund domiciles that present an alternative to traditional tax neutral offshore jurisdictions.

DTAs growing in number

- Finally, the availability of an extensive **double tax treaty network** in both Hong Kong and Singapore make them a preferred jurisdiction for structuring investments across key Asian destinations.
- The comparative ease of designing administration, operation and governance arrangements when fund manager, fund vehicles and investment holding structures are located in a single jurisdiction is increasingly attractive at a time when running a multi-national structure that traverses several jurisdictions is becoming more complex and coming under greater scrutiny.



Hong Kong continues to expand its tax treaty network – New double taxation agreement with India

What’s our future?

- Continuing massive government intervention in the private sector
- Coming to an end? The belief that relatively unconfined capitalism is the best approach to economic management.
- The end of rising globalization and the optimization of supply chains, Onshoring will likely become the increasing norm, especially for essential and critical areas like pharmaceuticals, defense, and healthcare infrastructure, and technology. And, yes, asset management.
- Big government coupled with higher taxes and significant tax reform and restructuring.
- More policies designed to create a fairer society and to inflate away unsustainable debt burdens.