

HONG KONG'S NEW UNIFIED TAX EXEMPTION FOR ONSHORE AND OFFSHORE PRIVATELY-OFFERED FUNDS

Date: 27 February 2019

Asia Investment Management Alert

By: Choo Lye Tan

Hong Kong's Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018 (the "Bill"), which will take effect on April 1, 2019, represents a significant development for Hong Kong's privately-offered funds industry by amending the Hong Kong profits tax exemption regime to "unify" the tax exemption treatment for onshore and offshore privately-offered funds operating out of Hong Kong. The new tax regime is structured to address the concerns of the Council of the European Union ("EU") in respect of the perceived "ring-fencing features" of Hong Kong's tax regime, as well as enhance the competitiveness of Hong Kong's fund industry, by creating a level playing field for all privately-offered funds operating in Hong Kong and subject to Hong Kong income tax, whether offshore or onshore.

The most noteworthy aspects of the Bill include:

- Extending Hong Kong's current tax exemption regime for offshore funds to onshore funds
- Providing more flexibility for funds to invest in Hong Kong private companies
- Eliminating "tainting concern", as only profits from "non-qualifying" transactions will be taxable (i.e., a fund will not lose its full tax exempt status for engaging in "non-qualifying" transactions)

This new regime is not only relevant to onshore funds currently subject to Hong Kong profits tax, but also provides offshore funds subject to Hong Kong profits tax [1] with more flexibility in their investment policies.

EXISTING TAX EXEMPTION REGIME

Under the existing law, the profits tax exemption is only applicable to funds with central management and control outside Hong Kong ("Offshore Funds") that do not invest in Hong Kong private companies. The exclusion of onshore funds from the profits tax exemption and the prohibition on Offshore Funds from investing in Hong Kong private companies in order to be eligible for the profits tax exemption was identified by the EU as an objectionable "ring-fencing" feature. As such, to prevent Hong Kong from being added to the black list of the EU's non-cooperative jurisdictions and exposed to defensive measures, the Hong Kong government proposed this new unified tax exemption regime.

NEW REGIME

Under the new regime, the profits tax exemption will apply to transactions in qualifying assets as defined in the Bill [2] (the "Qualifying Transactions") and to transactions incidental to the carrying out of the Qualifying Transactions

("Incidental Transactions"), provided that the receipts from such Incidental Transactions do not exceed 5% of the aggregate trading receipts from both the Qualifying Transactions and the Incidental Transactions, failing which the entire amount of the trading receipts from the Incidental Transactions will be subject to profits tax.

QUALIFICATIONS

To qualify for the profits tax exemption under the new regime,

- (a) the entity must be a "fund" as defined by the Bill; and
- (b) (i) the fund's transactions must be carried out or arranged by a "specified person" (i.e., persons licensed by the Securities and Futures Commission or authorized financial institutions); or
- (ii) the fund must be a "qualified investment fund".

TERMS DEFINED

Under section 20AM of the Bill, the proposed definition of "fund" is similar to the definition of "collective investment scheme" in the Securities and Futures Ordinance, and broadly means investment products of a collective nature over which investors do not have day-to-day investment management control, meaning that the investment is managed as a whole by or on behalf of the person operating the arrangements of the investment and/or the contributions of the investors and the profits or income from which payment is made to them are pooled. A business undertaking for general commercial or industrial purposes is not a "fund". To avoid corporate groups abusing the tax exemption, arrangements under which each investor is a corporation in the same group of companies as the manager operating the fund are excluded.

For a fund to be a "qualified investment fund" under the Bill, it must have more than four investors (excluding the originator and its associates) that contribute more than 90% of the fund's capital. There is also a 30% limit on the distribution of the fund's net proceeds to the originator and its associates.

SPECIAL PURPOSE ENTITIES

Special purpose entities (the "SPEs") that are partly or wholly owned by funds that qualify for the profits tax exemption are also exempt from profits tax to the extent they correspond to the percentage of shares or interests held by the exempt fund. An SPE is restricted to carrying on trade or activities for the purpose of holding, directly or indirectly, and administering the investee private companies.

NON-RESIDENT PERSON

On the Bill's effective date, the current tax exemption regime will run concurrently with the proposed unified tax exemption regime. Non-resident persons that do not qualify as a "fund" may rely on the current exemption regime, which is less flexible than the new regime.

ADDITIONAL REQUIREMENTS FOR INVESTMENTS IN PRIVATE COMPANIES

Since private companies may hold any type of asset in Hong Kong, to reduce the risk of tax evasion in respect of investments in private companies, a fund will need to meet two tests before it can benefit from the tax exemption: the immovable property test and the holding period/short-term assets test.

Immovable Property Test

The "immovable property test" provides that the investee private company should not directly or indirectly hold more than 10% of its assets in Hong Kong immovable property (excluding infrastructure). [3]

Holding Period Test and Short-term Assets Test

The "holding period test" requires that investments must be held for at least two years. If the holding period test fails, a "short-term assets test" will apply and requires that the fund not have a controlling stake in the investee private company, or the investee private company not hold more than 50% of its assets in short-term assets (assets held for less than three years), the intent being that a fund will not be eligible for tax exemption if it directly trades in short-term assets.

LATEST NEWS ON THE REGIME

The Inland Revenue Department has indicated through a consultation process with tax professionals and industry bodies that it is aware that further clarity is needed on certain technical issues and that these will be addressed through Departmental Interpretation and Practice Notes as opposed to amendments to the Bill itself, and that it is on track to meet the effective date of April 1, 2019.

CONCLUSION

In addition to extending the tax exemption to onshore privately-offered funds, the new unified tax exemption regime also provides more flexibility to funds that may invest in Hong Kong companies in that it clarifies and removes the "tainting concern" that the fund will lose its full tax exemption treatment if any one or more of its transactions is non-qualifying. As such, this new unified tax regime brings the Hong Kong tax environment in line with European standards and, to the extent a fund is subject to Hong Kong tax, it should assess its current structure, operations and investment focus and portfolio to determine if the new profits tax exemption applies to it or, if not, if it can and should restructure itself so that it may best benefit from it.

NOTES

[1] Under current law, profits tax is charged to offshore funds carrying on a trade, profession or business in Hong Kong in respect of their assessable profits arising in or derived from Hong Kong from such trade, profession or business. Whether or not an offshore fund is carrying on a trade, profession or business in Hong Kong is largely a question of fact and degree, which can only be determined after examining all the relevant facts and circumstances.

[2] Securities; shares, stocks, debentures, loan stocks, funds, bonds, or notes of, or issued by, a private company; futures contracts; foreign exchange contracts; deposits other than those made by way of a money-lending business; bank deposits; certificates of deposit; exchange-traded commodities; foreign currencies; over-the-counter derivative products; and an investee company's shares co-invested by a partner fund and Innovation and Technology Venture Fund Corporation under the Innovation and Technology Venture Scheme.

[3] Immovable property is defined as land (whether covered by water or not); any estate, right, interest or easement in or over any land; and things attached to land or permanently fastened to anything attached to land,

but does not include infrastructure. Infrastructure means any publicly or privately owned facility providing or distributing services for the benefit of the public, and includes any water, sewage, energy, fuel, transportation or communication facility.

KEY CONTACTS



CHOO L. TAN
PARTNER
HONG KONG
+852.2230.3528
CHOO LYE.TAN@KLGATES.COM

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.