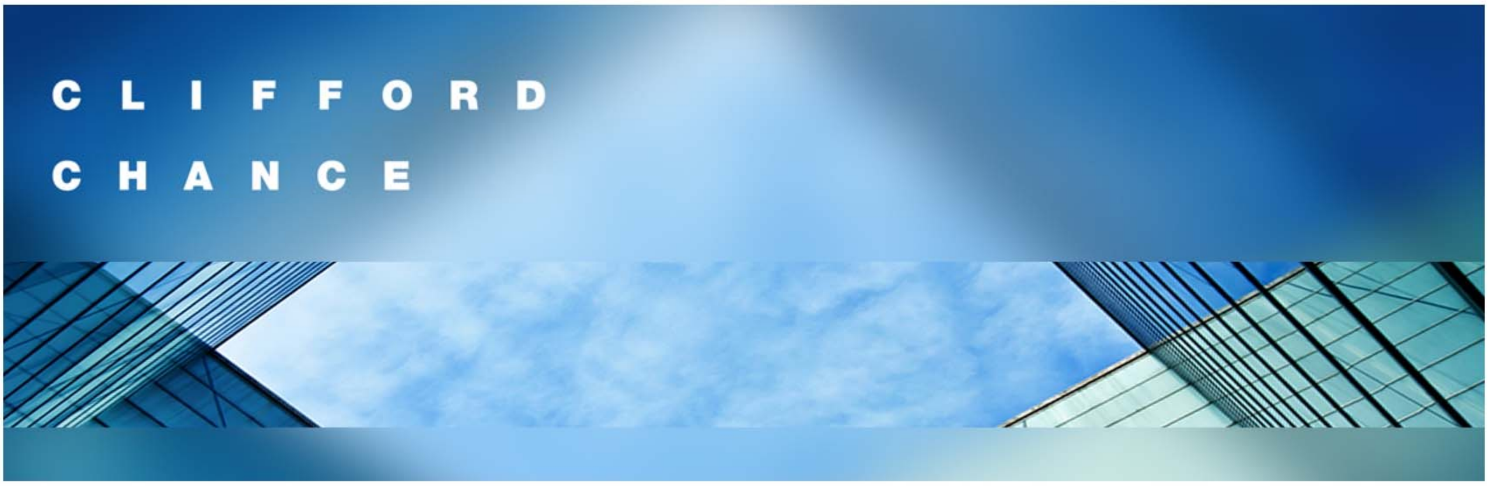

HONG KONG TO INTRODUCE EXPANDED PROFITS TAX EXEMPTION REGIME FOR FUNDS

On 7 December 2018, the Hong Kong government gazetted the Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018 (the "Expanded Funds Tax Exemption"). The Bill introduces a new preferential tax regime for qualifying funds and provides fund managers an alternative to the existing offshore funds tax regime, which has been in place for over a decade (the "existing regime"). The Expanded Funds Tax Exemption would apply to a wide range of offshore and onshore funds and proposes to remove a number of problematic aspects of the existing regime - in particular, its ring-fencing and tainting features.

Key issues

- The Expanded Funds Tax Exemption would remove the tainting features of the existing regime.
- The removal of ring-fencing features would provide private equity funds more flexibility in investing into Hong Kong and non-Hong Kong private companies.
- The exemption covers all funds whether domiciled in Hong Kong or not that meet the prescribed definition of a "fund" under the new rules.
- The new rules would cover open-ended fund companies and repeal the recently enacted tax rules for open-ended fund companies.
- When enacted, the new rules would apply from 1 April 2019.

INTRODUCTION

The motivation for introducing a new funds tax regime in Hong Kong is two-fold. First, the European Union ("EU") views the existing regime as exhibiting ring-fencing features that are harmful to global tax competition. The existing regime excludes onshore funds from enjoying tax concessions and the scope of qualifying investments excludes Hong Kong private companies. Hong Kong has committed to modifying its preferential tax regime for funds to address these concerns, failing which Hong Kong may be at risk of being blacklisted by the EU as a non-cooperative jurisdiction for tax purposes. Second, the existing regime has some significant limitations making it unattractive for fund managers to fully take advantage of the offshore funds tax exemption. This has led to a view that the existing regime has not been as effective as it could be to develop Hong Kong into a leading asset and wealth management centre. Among others, the tainting features of the existing regime raised concern that a single non-qualifying investment could render the entire fund ineligible for the profits tax exemption. Moreover, the existing regime does not apply to investments in Hong Kong private companies or non-Hong Kong private companies with business operations in Hong Kong, resulting in the need to do careful due diligence to ensure private equity targets do not have Hong Kong business connections.

Key Features of New Rules

The Expanded Funds Tax Exemption would have the following key features.

- The exemption would cover all funds whether domiciled in Hong Kong or not that meet the prescribed definition of a "fund" under the new rules. The new rules would define "fund" broadly in a manner similar to how "collective investment schemes" are defined under Part 1 of Schedule 1 to the Securities and Futures Ordinance of Hong Kong ("SFO"). For the avoidance of doubt, "fund" would also be defined to specifically include sovereign wealth funds. Anti-avoidance measures would be in place to exclude vehicles that might technically meet the characteristics of a collective investment scheme but are in substance business undertakings for general commercial or industrial purposes. Such business undertakings are not intended to be the beneficiaries of the new preferential tax regime. The new rules would define "business undertaking" by reference to a list of activities that would be carved out from the definition of a "fund." This carve out list would include, among others, finance-related activities such as money-lending which may affect private lending activities. Hence, there may be circumstances where some offshore investment vehicles may not fall squarely within the definition of a "fund" under the new rules but would nevertheless meet the exemption requirements under the existing regime. The Hong Kong government has anticipated this possibility and is proposing to retain the existing offshore funds tax regime in its entirety such that funds may choose whether to take advantage of the exiting exemption regime or the new one.
- The exemption would remove the tainting features of the existing regime. Under the existing regime, the profits tax exemption is extended to profits derived from "specified transaction" and transactions incidental to specified transactions ("incidental transactions"). The conduct of any other business in Hong Kong will jeopardize the fund's eligibility for the tax exemption as a whole, meaning that even a single non-qualifying transaction could cause the fund's entire portfolio (including qualifying ones) to lose its profits tax exemption. The Expanded Funds Tax Exemption would continue to limit the profits tax exemption to specified qualifying transactions and incidental transactions. However, it removes the tainting penalty, such that Hong Kong sourced revenue profits derived from investments in non-qualifying transactions would simply be taxed without jeopardizing the exemption for qualifying transactions. This would make the New Profits Tax Exemption potentially more attractive to private equity funds that have mixed exposure to qualifying and non-qualifying investments.
- The removal of ring-fencing features would provide private equity funds more flexibility in investing into Hong Kong and non-Hong Kong private companies. However, the new rules would impose a set of anti-avoidance restrictions (pursuant to the immovable property, holding period and short-term asset tests) that target investments in Hong Kong real estate as well as short term private equity holdings. Under these restrictions, profits arising from disposals of private companies that hold, directly or indirectly, more than 10% of their assets in Hong Kong real estate would not be tax exempt (the "immovable property test"). For investments in private companies that hold, directly or indirectly, 10% or less of their assets in Hong Kong real estate, profits tax exemption would be available only if the fund meets a two-year holding period requirement (the "holding period test"). If the fund has held the investment for shorter than two years, the exemption could still apply provided the fund does not have a controlling

stake in the private company, or alternatively, 50% or less of the private company's assets comprise short term assets (the "short-term asset test").

- As with the existing regime, the new rules would require qualifying transactions to be either carried out or arranged in Hong Kong by a specified person (ie, corporation licensed or an authorised financial institution registered under the SFO), or the fund must meet the definition of a "qualified investment fund."
- The new rules would cover open-ended fund companies ("OFC") and repeal the recently enacted OFC tax rules. The repeal of the OFC tax rules would mean that some of the more onerous eligibility requirements under those rules will no longer apply, including the "not closely held" conditions.
- The anti-round tripping provisions under the existing regime would remain to deem certain Hong Kong resident investors holding a beneficial interest of 30% or more in a tax-exempt fund (or any percentage if the fund is the resident person's associate) to have derived assessable profits from the fund.

Implications

The introduction of the Expanded Funds Tax Exemption is a welcome development and expected to bring greater certainty to fund managers looking to expand their activities in Hong Kong. The Hong Kong government hopes the new rules will further aid the development of Hong Kong as the region's preferred asset and wealth management centre.

Despite the favourable changes proposed in the new rules, there remains some areas for further consideration as well as aspects where clarity is required.

- For credit funds, it is unclear whether the Inland Revenue Department ("IRD") will continue to maintain its view under DIPN 43 that the holding of securities to earn interest income is not a "transaction in securities". Given that there are no explicit provisions to the contrary under the new rules, the IRD may be expected not to deviate from this position. In such case, Hong Kong sourced interest income would continue to be considered income from "incidental transactions" under the new rules and exempt from profits tax only if it does not exceed a 5% deminimis threshold.
- The new rules would extend the profits tax exemption to special purpose vehicles ("SPVs") of a qualifying fund. However, as with the existing regime, the SPV can only "administer and hold" shares in underlying SPVs and private companies. Hence, fund managers using SPV structures will need to continue to ensure their SPVs do not exceed this limited scope of activities while balancing this against the need to have "substance" for purposes of accessing double tax treaties.
- The new rules would extend their application to all qualifying funds irrespective of whether they are resident in Hong Kong or not. Although this opens the door to considering onshore fund vehicle options in Hong Kong, Hong Kong does not yet offer an onshore limited partnership vehicle to fully exploit the advantages of the Expanded Funds Tax Exemption. Currently, the only viable onshore fund vehicle in Hong Kong is the OFC.

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