

HONG KONG TAX

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NEW PRACTICE GUIDE ISSUED ON THE UNIFIED FUND EXEMPTION REGIME



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Following the implementation of a unified profits tax exemption for all privately-offered funds from 1 April 2019, the Hong Kong Inland Revenue Department (IRD) issued at the end of June 2020 its much-awaited Departmental Interpretation and Practice Notes No. 61 (DIPN 61) on the new tax exemption laws.

This newsletter highlights some of the IRD's views in DIPN 61, which would interest the asset management community. Our earlier newsletter on the unified fund exemption (UFE) can be found at [March 2019 - Hong Kong Introduces Unified Fund Exemption Regime](#).

References to sections and schedules refer to sections and schedules of the Hong Kong Inland Revenue Ordinance, unless otherwise stated.

Meaning of a "fund" for UFE purposes

One of the key requirements for profits tax exemption is that the fund meets the prescribed definition of a "fund" under the UFE regime. One key feature in the definition of such a "fund" is that the participating persons do not have day-to-day control over the management of the property being pooled and managed as a whole under the fund. This may have led to concerns as to whether funds that receive participations from the fund management group might be left out from the scope of the tax exemption.

The IRD now clarifies in DIPN 61 that in order for an arrangement to satisfy the requirement that "the participating persons do not have day-to-day control over the management", it is sufficient that any one of the individual participating persons is not a party to exercising day-to-day control, regardless of the extent of their interest in the fund. The IRD expressly states that all investors must have day-to-day control over the management of their properties for an arrangement not to be a fund and that even if

one investor does not have day-to-day control, the arrangement could still be a fund, subject to fulfilment of other conditions.

Sale of shares upon listing

One of the other areas which many investors may pay special attention is whether the scope of the UFE covers share sales upon an initial public offering (IPO). The IRD confirms in DIPN 61 that if the fund sells its investment in the investee private company through an IPO, the IRD views it is no different from a transaction in listed securities or a transaction in securities of an investee private company. Accordingly, the fund will continue to be eligible for profits tax exemption in respect of the divestment if the other exemption conditions remain satisfied.

Tax residence of the fund

The IRD has made interesting comments in DIPN 61 relating to the determination of the tax residence of a fund. The IRD specifically comments that if the regional investment platform of a fund is located in Hong Kong for acquisition and management of a diversified portfolio of private market investments in various territories in a regional group that includes Hong Kong and the decision to establish the regional investment platform in Hong Kong is mainly driven by the availability of fund executives with knowledge of regional business practices and regulations, then the benefits under a double tax agreement or arrangement should be available to the fund. Further, the IRD comments that the fact that the general partner resides outside Hong Kong does not necessarily lead to the conclusion that the central management and control of the private equity fund is located outside Hong Kong and that where the residence of the private equity fund is exercised by the general partner, the residence of the private equity fund is the place where the central management and control is exercised by the general partner.

Reading between the lines, it seems the IRD is acknowledging that the central management and control of a private equity fund may be exercised by persons other than the general partner, and such persons may be, for instance, the fund executives in the regional investment platform as described by the IRD in DIPN 61. If the fund is a corporation, the IRD reaffirms its views that the central management and control is exercised by the directors of such corporate fund. If the fund is a trust, the IRD views that the central management and control of the trust estate is exercised by the trustee.

Tax residence of special purpose entities

Once again, the IRD reaffirms its views that the place of residence of a special purpose entity (SPE), wholly or partially owned by a fund, generally follows that of the fund despite that the SPE might be incorporated, registered or appointed elsewhere.

It has been an industry-wide issue that given the operation of an SPE is restricted, by definition for the purpose of tax exemption, to holding and administering investee private companies, it is often difficult for an SPE to demonstrate substantial business activities in Hong Kong when the SPE applies for a certificate of resident status. In DIPN 61, the IRD reiterates its position that in deciding whether a certificate of resident status could be issued to an SPE, all the facts and circumstances would be examined to determine whether the SPE has substantial business in Hong Kong (eg permanent office or employees in Hong Kong to hold and administer its investment in investee private companies).

This issue was discussed in the 2020 Annual Meeting between the IRD and the Hong Kong Institute of Certified Public Accountants. The minutes are expected to be published later this year. BDO tax team will keep our clients updated on this.

No deemed tax loss under anti-round tripping provisions

There are anti-round tripping provisions under the UFE, similar to those under the offshore fund exemption which may have been known within the asset management community. The IRD stresses that the anti-round tripping provisions only impose deemed profits but not losses on a resident person caught by such provisions as these provisions are intended to discourage a resident person for taking advantage of the profits tax exemption by round tripping through a fund. A resident person caught by the anti-round tripping provisions will not be entitled to claim any proportionate amount of the losses sustained by a fund or an SPE held by the fund, in which the resident person holds a beneficial interest

No stamp duty exemption

Hong Kong stamp duty on transfer of shares in a corporate fund that takes the form of a Hong Kong incorporated company, including an open-ended company, is not exempted under the UFE regime. The IRD notes that if the sale or transfer involves Hong Kong stock as defined in the Stamp Duty Ordinance, there will be stamp duty consequences unless exemptions provisions therein apply.

Hong Kong tax filing for funds?

The IRD does not address specifically whether or in what scenario a fund may be required to register such business in Hong Kong and accordingly file tax returns in Hong Kong. What the IRD does note in DIPN 61 is that though the central management and control may be exercised by the general partner in Hong Kong, the actual business operations of a private equity fund may take place outside Hong Kong. It is unclear whether the IRD says this because it does not intend to require offshore incorporate/established funds to be required to file tax returns in Hong Kong simply because such funds now place their central management and control in Hong Kong, or it has other thoughts in mind. The asset management industry will welcome more clarity in this area.

The Hong Kong Limited Partnership Fund Ordinance, enacted on 17 July 2020 and coming into operation on 31 August 2020, introduces a specific regulatory regime for limited partnership funds in Hong Kong. The key compliance obligations of a limited partnership in this new regime (HKLP) include:

- It has to be constituted by a limited partnership agreement and must have a registered office in Hong Kong;

- It has to be registered with the Registrar of Companies and has an obligation to file an annual return;
- It has to appoint a local auditor;
- It has to appoint a qualified person to carry out anti-money laundering and counter-terrorist financing measures; and
- There are requirements for proper custody arrangements and record keeping.

With a registration with the Registrar of Companies, a HKLP would naturally be registered with the Business Registration Office and issued with profits tax returns for filing.

The various compliance requirements and hence costs may make a HKLP appear less attractive especially as an offshore fund could still qualify for profits tax exemption. Private equity funds may be more incentivised to locate their funds in Hong Kong, if the Financial Secretary's proposal of tax incentive on carried interest in his budget speech earlier this year is to be implemented where such tax incentive is generally expected to be available to Hong Kong registered funds only.

The UFE provisions remain quite complex. Please contact the BDO tax team to discuss how we may assist you in revisiting existing structures and/or launching new funds.

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