

HONG KONG TAX

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HONG KONG INTRODUCES UNIFIED FUND EXEMPTION REGIME



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The new provisions in the Inland Revenue Ordinance as amended by the Inland Revenue (Profits Tax Exemption For Funds) (Amendment) Ordinance 2019 was gazetted on 20 February 2019 and will become operative on 1 April 2019 to offer unified profits tax exemption to all privately-offered funds.

This newsletter highlights the salient features of the new unified fund exemption (UFE). Certain aspects of the new regime are complicated. The Inland Revenue Department (IRD) will issue a departmental practice note to explain its interpretation and assessing practices in this connection. Please discuss with your tax advisors should you intend to avail of the new UFE.

References to sections and schedules refer to sections and schedules of the Inland Revenue Ordinance (IRO), unless otherwise stated.

Key conditions of the UFE

Regardless of its tax residence, a **fund** is exempt from profits tax in respect of its assessable profits if the following conditions are met throughout a year of assessment:

- It meets the definition of a **fund** for the purpose of the tax exemption;
- The assessable profits are earned from **qualifying transactions** (and **incidental transactions** subject to a 5% threshold); and
- The qualifying transactions are carried out in Hong Kong by or through, or arranged in Hong Kong by a **specified person**; or alternatively the fund is a **qualified investment fund**.

The meaning given to a fund for the purpose of the tax exemption is similar to that of a collective investment scheme under the Securities and Futures Ordinance (SFO). One key feature is that the participating persons do not have day-to-day control over the management of the property being pooled and managed under the fund. Certain arrangements are specifically excluded, such as group captive funds, employee funds and business undertaking for general commercial or industrial purposes.

Qualifying transactions refer to transactions in assets of a class specified in Schedule 16C:

1. Securities
2. Shares in private companies (with exceptions)
3. Futures contracts
4. Foreign exchange contracts
5. Deposits other than those made by way of a money-lending business
6. Deposits made with a bank*
7. Certificates of deposits*
8. Exchange-traded commodities
9. Foreign currencies
10. OTC derivatives*
11. An investee company's shares co-invested by a partner fund and the Innovation and Technology Venture Fund (ITVF) Corporation under the ITVF Scheme

The meaning of **incidental transactions** is similar to what is known under the existing offshore fund exemption (OFE) and a similar 5% safe harbour threshold applies.

A **specified person** is a corporation licensed or authorised financial institution registered under Part V of the SFO to carry on a business in any regulated activity.

A **qualified investment fund** has a similar meaning as a qualifying fund under the OFE regime, ie a fund after final closing having at least five (5) investors (as defined in the IRO) with capital commitments made by investors exceeding 90% of the aggregated capital commitments, and the originator together with its associates receiving no more than 30% of the fund's net proceeds.

What has been changed from the OFE

The definition of a **fund** is wide enough to cover corporations or partnerships, Hong Kong incorporated or non-Hong Kong incorporated. A fund may be centrally managed and controlled in Hong Kong or outside Hong Kong.

There is no "tainting" such that an eligible fund could still benefit from profits tax exemption on its qualifying transactions even if it carries out other transactions. Those other transactions (if not incidental transactions and/or over the 5% threshold) would be subject to tax separately.

Investment into Hong Kong private companies and businesses is permitted provided the private company passes the following tests:

Hong Kong immovable property test: the private company does not hold directly or indirectly more than 10% of its assets in immovable property (other than infrastructure) in Hong Kong; and

Holding period test: the investment in the private company has been held by the fund for at least two years; or

Short-term asset test: if the holding period test is not satisfied, (i) the fund does not have a controlling stake in the private company; or (ii) where the fund has a controlling stake in the private company, the private company does not hold more than 50% of the value of its assets in short-term assets (as defined in the IRO).

An open-ended fund company (OFC) will now come under the new UFE and the previous stringent OFC exemption conditions such as the "non-closely held" requirement and deemed taxation of carried interest are now removed.

What stays the same as the OFE

Profits tax exemption is offered to a special purpose entity (SPE) owned by a tax-exempt fund. It remains a limiting factor that the activity of the SPE has to be limited to holding and administering investee private companies; further, the tax exemption for an SPE is narrower than the fund, ie an SPE is only exempt from profits tax in respect of assessable profits from transactions in specified securities (as defined in the IRO) in investee private companies, or interposed SPE.

The new UFE regime also includes anti-avoidance provisions to deem certain Hong Kong residents taxable in respect of their proportionate share of the assessable profits of a tax-exempt fund and SPE irrespective of whether the residents have received or will receive from the fund any distributions.

The OFE regime remains relevant

The existing OFE regime will run in parallel with the new UFE regime on and after 1 April 2019 to offer profits tax exemption to a non-resident person which falls short of a **fund** for the purposes of the UFE provided the non-resident person satisfies the exemption conditions under the OFE. The conditions and extent of tax exemption under the OFE remain unaffected by the introduction of the UFE regime.

BDO observations

The introduction of the UFE is a long-awaited positive step finally taken to further promote Hong Kong as an asset management centre. We look forward to the IRD's practice note which should clarify its interpretation and practical administrative issues.

Some of the areas that appears to be unresolved under the UFE include:

- Hong Kong stamp duty on transfer of shares in corporate fund that takes the form of a Hong Kong incorporated company including an OFC.
- Whether receipt of dividends from a Hong Kong corporate fund is specifically tax exempt under Section 26(a) in the absence of any overriding provision such as OFC-specific Section 20AJ(2) which is now repealed.
- Whether listed securities held by an SPE of a tax-exempt fund could benefit from profits tax exemption as if the listed securities were held directly by the fund.

The definition of investee private companies appears to be narrow as it is currently written because it precludes investees in other corporate forms, such as trust, partnership or other non-common law forms.

It is disappointing that the IRD still takes the view that "transaction" refers only to the buying and selling of securities and not to the holding of securities to generate income. As a result of this interpretation, interest from debt

* As defined in Part 1 of Schedule 1 to the SFO

securities can only be income from incident transactions and subject to the 5% threshold. That means credit funds still cannot benefit from Hong Kong's fund exemption regimes.

It is also important to keep in mind that a fund centrally managed and controlled in Hong Kong may be viewed as carrying on a business in Hong Kong although it is specifically exempted from the payment of profits tax under the UFE regime. In that case, the fund may need to be registered under the Business Registration Ordinance and have tax filing obligations from a compliance perspective. In comparison, a Singapore resident fund under the Onshore Fund Exemption Scheme (Section 13R of the Singapore Income Tax Act) is required to file annual tax returns.

If the onshore fund takes the form of an OFC, there would be regulatory compliance obligations with the Securities and Futures Commission, in addition to tax and corporate compliance.

The UFE may lead to opportunities for asset management groups to simplify and streamline their operating protocol, for instance funds with offshore management may consider "on-shoring" in Hong Kong particularly in view of the recent introduction of substance requirements in offshore tax jurisdictions eg the Cayman Islands.

Please contact BDO tax team to discuss how we may assist you in revisiting existing structures and/or launching new funds.

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