

# New Tax Developments Affecting Management Fees: What Hong Kong Fund Managers Should Know

*The Hong Kong tax authorities have issued new guidance which may affect the arrangements used by fund management groups to minimize tax on management fees and performance fees. In this article, we examine the current taxation position and set out defensive steps which fund management groups may take to minimize the risk of an increased tax burden.*

On December 4, 2009, the Hong Kong Inland Revenue Department (“IRD”) issued Departmental Interpretation and Practice Note No. 46 (“DIPN 46”). Whilst DIPN 46 is not specifically aimed at the funds industry, it may substantially affect the tax liabilities of fund management groups operating in Hong Kong.

## Background

Hong Kong based hedge funds are often managed by a fund management group comprising an offshore manager (“Offshore Manager”) and a Hong Kong sub-manager (“Hong Kong Manager”). Under these arrangements, the fund delegates investment management authority to the Offshore Manager which, in turn, delegates certain management functions to the Hong Kong Manager. At the same time, the fund will pay management fees and performance fees to the Offshore Manager and the Offshore Manager will pay a service fee to the Hong Kong Manager.

In many cases, the service fee is calculated as the operating costs of the Hong Kong Manager plus a mark-up of between 5 to 10 per cent. However, other methods of calculating the service fee may be used.

The transfer pricing and anti-avoidance provisions of the Inland Revenue Ordinance (“IRO”) enable the IRD to challenge the arrangements between

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*“[P]rovisions of the Inland Revenue Ordinance enable the Inland Revenue Department to challenge the arrangements between the Offshore Manager and the Hong Kong Manager in certain circumstances where the arrangements provide a disproportionate tax savings to the fund management group.”*

the Offshore Manager and the Hong Kong Manager in certain circumstances where the arrangements provide a disproportionate tax savings to the fund management group.

DIPN 46 may signal that the IRD intends to more closely scrutinize these types of arrangements and in this case, provides guidance as to the IRD’s approach.

## The Law

The IRO includes both transfer pricing provisions and anti-avoidance provisions. At the same time, it empowers the Hong Kong government to enter into double taxation agreements which may over-ride these provisions. At present, Hong Kong has entered into double taxation treaties with Luxembourg and Belgium, amongst others, but has not entered into double taxation treaties with the Cayman Islands or the British Virgin Islands. Fund management groups with an Offshore Manager in a jurisdiction which has signed a double taxation treaty should be aware that the transfer pricing arrangements may differ from those set out in this article.

### Transfer Pricing

The IRO, s. 20(2) provides that a non-resident person, such as an Offshore Manager, is deemed to carry on a business in Hong Kong and thus, may be subject to profits tax, if the following conditions are satisfied:

- the non-resident person carries on business with a resident person, such as the Hong Kong Manager,
- the non-resident person and the resident person are closely connected, and
- the course of such business is so arranged that it produces to the resident person either no profits which arise in or derive from Hong Kong or less than the

ordinary profits which might be expected to arise in or derive from Hong Kong.

### Anti-Avoidance

Broadly, a taxpayer is engaged in tax avoidance when he reduces his tax liability without incurring the economic consequences that the legislature intended to be suffered by a taxpayer qualifying for such reduction in his tax liability. In contrast, a taxpayer is engaged in tax mitigation where he takes advantage of a fiscally attractive option afforded to him by tax legislation and genuinely suffers the economic consequences that the legislature intended to be suffered by those taking advantage of the option.

In this regard, the IRO sets out a number of anti-avoidance provisions. A key anti-avoidance provision is s. 61A, which permits the IRD to assess the tax liability of a person in such manner as it considers appropriate to counteract a tax benefit from a transaction (including a scheme or operation) where the sole or dominant purpose of the transaction is to enable the person to obtain such a tax benefit. In determining whether the sole or dominant purpose of a transaction is to enable a person to obtain a tax benefit, the IRD must have regard to prescribed statutory criteria.

Under this anti-avoidance provision, the IRD may seek to tax the Hong Kong Manager as if it were the recipient of the management and performance fees instead of the Offshore Manager.

### DIPN 46

DIPN 46 seeks to apply the Organisation for Economic Co-operation and Development’s Transfer Pricing Guidelines for Multinational Enterprises in Hong Kong except where they are incompatible with the express provisions of the IRO. DIPN 46 reinforces Departmental

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Interpretation and Practice Note No. 11A (“**DIPN 11A**”) in which the IRD indicated that it would seek to apply the anti-avoidance provisions of the IRO to taxpayers carrying on a business in Hong Kong seeking to book Hong Kong profits to an offshore affiliate.

DIPN 46 is general in nature and does not specifically discuss the fund management industry. Like all guidance issued by the IRD, it has no force of law and a court may disregard it. Nevertheless, it clarifies the IRD’s position on the law relating to transfer pricing and failure to adhere to the IRD’s position may increase the risk of tax enforcement action. In that respect, DIPN 46 provides indications as to the degree of tax enforcement risk which fund management groups may face.

### **Arm’s Length Principle**

Broadly, DIPN 46 requires associated enterprises to operate on an arm’s length basis. It requires associated enterprises to charge the same price, royalty and other fee in relation to a controlled transaction as that which would be charged by independent enterprises in an uncontrolled transaction in comparable circumstances. It thus requires the Hong Kong Manager to charge the Offshore Manager the same fee that it would charge an unrelated enterprise.

If this requirement is not met, the IRD has indicated in DIPN 46 that it will make adjustments to transactions under the provisions of the IRO.

### **Limitations in Transfer Pricing Law**

Interestingly, whilst DIPN 46 references IRO, s. 20(2), it neither discusses to what extent the IRD may use this section nor how the IRD may interpret this section. It is unclear why the IRD has elected not to rely on this section.

One possible reason is that the IRD recognizes that the current drafting of the section does not give it sufficient powers to combat intra-group tax plans. Although s. 20(2) would appear to give the IRD specific powers to combat non-arm’s length arrangements which limit profits tax, Hong Kong profits tax is payable only where a person not only carries on a business in Hong Kong but also where the person has profits which arise in or derive from Hong Kong. The section deems the non-resident person to carry on a business in Hong Kong but does not deem the non-resident person’s profits from course of its business with the resident person to arise in or derive from Hong Kong. Thus, to the extent that the non-resident person has no profits which arise in or derive from (or are deemed to arise in or derive from) Hong Kong, the non-resident person may nevertheless not be subject to profits tax even though he may be deemed to carry on a business in Hong Kong.

### **Limitations in Anti-Avoidance Law**

Whilst the anti-avoidance provisions in IRO, s. 61A are broad, judicial precedent suggests that the section applies not because the arrangements are made otherwise than on an arm’s lengths terms (as suggested in DIPN 46) but because the arrangements are made for the sole or dominant purpose of obtaining a tax benefit. This suggests that in some cases, arrangements which fall short of satisfying the arm’s length test may, nevertheless, survive an attack by the IRD on the basis that such arrangements were not solely or predominantly motivated by a tax benefit.

### **Tax Enforcement Risk**

It is possible that DIPN 46 increases the tax enforcement risk of fund management groups on the basis that the arrangements do not satisfy the arm’s length test. To

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the extent that the sole or dominant purpose of the interposition of the Offshore Manager is to minimize the profits tax of the fund management group, such tax enforcement action may succeed.

In this regard, the Hong Kong government has historically favoured the development of the fund management industry in Hong Kong and has set out a framework for exempting funds themselves from profits tax to foster the development of the industry. Enforcement action against the fund managers would seem to run counter to this policy. In this regard, it is significant to note that:

- DIPN 11A earlier established IRD intolerance to the use of offshore affiliates to book profits in circumstances where the offshore affiliate does not carry out substantial activity and at the time of its issuance, there was no change in enforcement policy against fund managers;
- DIPN 46 does not specifically focus on the fund management industry; and
- there has not been any apparent and concerted recent tax enforcement activity against fund management groups in particular.

Enforcement policy however, can change at any time and it is possible that DIPN 46 signals such a change. Hong Kong based fund managers may therefore wish to consider if their tax structure, if challenged, would withstand scrutiny. If found to have engaged in tax avoidance, even in the absence of fraud or wilful intent to evade tax, fund managers may be subject to a fine up to 3 times the tax that should have been payable.

## Defensive Steps

Fund management groups concerned about Hong Kong profits tax liability in respect of their management and performance fees should consider seeking tax advice.

In this regard, the anti-avoidance provisions of the IRO depend upon proof of the sole or dominant purpose of a transaction. Whilst legitimate tax advice would not advise any taxpayer to engage in an illegal course of conduct, to the extent that the disclosure to the IRD of any legitimate tax advice may facilitate a finding that the sole or dominant purpose of a transaction is to obtain a tax benefit, it may be beneficial to obtain tax advice from legal counsel. Communications between legal counsel and client are subject to legal professional privilege and hence, enjoy a degree of confidentiality that advice received from other tax advisers do not enjoy.

## Transfer Pricing Documentation

Fund management groups should consider engaging a tax adviser to prepare transfer pricing documentation. Such documentation provides a basis for determining whether arrangements between an Offshore Manager and a Hong Kong Manager are on arm's length terms and for identifying the purpose of the arrangements. Amongst other things, such documentation provides written evidence of services rendered by each of the Offshore Manager and the Hong Kong Manager, the terms and conditions of the arrangements between the Offshore Manager and the Hong Kong Manager, a survey of comparable arrangements and the factors that led to the adoption of a particular pricing methodology. Such documentation must, of course, not only recognize tax concerns but also regulatory concerns.

*“Where the Offshore Manager does not carry out substantial activity... and the commercial justification for the Offshore Manager is not apparent, there is a greater risk not only of tax enforcement but also of a finding that the sole or dominant purpose of the interposition of the Offshore Manager is to obtain a tax benefit.”*

### Pricing Methodology

Fund management groups should carefully consider the method by which the fees between the Offshore Manager and the Hong Kong Manager is determined. The method should best reflect the fees which would be payable in an arm’s length arrangement. Possible methods include:

- Comparable uncontrolled price method – the fee is based on a comparable transaction between a manager and a sub-manager which are unrelated;
- Cost plus method – the fee is based on the costs incurred by the Hong Kong manager in providing the services to the Offshore Manager plus a mark-up; or
- Profit split method – the fee is based on a split of the actual or projected aggregate profits of the Offshore Manager and the Hong Kong Manager which reflects their respective economic contribution to those profits.

Whilst the cost plus method may be regarded as inconsistent with the arm’s length principle given that many asset management arrangements on an arm’s length basis are priced on the basis of a percentage of assets under management, this is not necessarily so. In the context of service company providing services for an unincorporated firm, the IRD itself recognizes that a commercially realistic figure for the firm to pay for qualifying services can reflect not only the costs of the service company which are directly attributable to providing the relevant services to the firm but also an appropriate margin or mark-up to covert he overheads and profits of the service company.

### Activities of Offshore Manager

Fund management groups should consider carefully the role to be played by the Offshore Manager. Where the

Offshore Manager does not carry out substantial activity, the Hong Kong Manager performs all the activities in Hong Kong which in substance give rise to profits and the commercial justification for the Offshore Manager is not apparent, there is a greater risk not only of tax enforcement but also of a finding that the sole or dominant purpose of the interposition of the Offshore Manager is to obtain a tax benefit.

In this regard, it is significant to note that under the laws of the place of incorporation of many Offshore Managers, the Offshore Manager is required to mainly carry on its business outside of that place to qualify for tax exemption. At the same time, the Offshore Manager may not be in a position to carry on its business in Hong Kong without becoming liable to Hong Kong profits tax and becoming subject to licensing requirements of the Securities and Futures Commission in Hong Kong.

Transfer pricing documentation should fully support the role played by the Offshore Manager.

### Advance Ruling

Fund management groups, particularly those who have yet to formalize their corporate structure, may consider obtaining an advance ruling from the IRD as to how the provisions of the IRO would be applied in their specific proposed circumstances.

### Conclusion

In light of DIPN 46, fund management groups which comprise managers in Hong Kong and an offshore tax haven jurisdiction may wish to consider whether the arrangements between the Hong Kong Manager and the Offshore Manager are likely to be the subject of scrutiny by the IRD and if so, whether they would survive such scrutiny.