Tax Law: Proposals to Relax Profits Tax Exemption for Hong Kong Managed Funds

In response to pressure from the European Union, the Hong Kong Government has proposed amending the current offshore funds exemption so that the exemption will no longer require that a fund be non-resident and so that relief will even be available for private equity investments with a Hong Kong focus. If these proposals are adopted, Hong Kong resident funds will qualify for tax relief, thereby eliminating the need to take the management of Hong Kong sponsored funds offshore. At the same time, private equity funds may be able to invest in Hong Kong private businesses. In this article, we explore the government's proposals and what they may mean for Hong Kong's asset management industry.

On April 4, 2018, the Hong Kong Government introduced proposals to relax conditions by which private funds may be exempt from profits tax. While the proposals confirm a long term trend to encourage the development of the Hong Kong asset management industry by neutralizing tax burdens on funds managed from Hong Kong, these proposals are in fact prompted by criticisms levelled by the Council of the European Union.

Under the proposals, ring-fencing measures now in place at both the fund level and at the portfolio level will be eliminated. In broad terms, at the fund level, exemptive relief will now be available to funds, whether resident or non-resident of Hong Kong, and at the portfolio level, exemptive relief will now be available for a wider range of investments, including investments in Hong Kong. Whilst the precise contours of the proposals are as yet unclear, the proposals signal a possible major shift in tax law.

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History

Prior to 2006, Hong Kong provided express exemptive relief for regulated funds including funds authorized by the Securities and Futures Commission ("**SFC**") from profits tax but there was doubt as to whether or not unregulated funds, including the vast majority of hedge funds, were exempt from profits tax.

2006 Exemption

The Revenue (Profits Tax Exemption for Offshore Funds) Ordinance 2006 marked a dramatic change in the tax position, providing express exemptive relief to persons not resident in Hong Kong (*e.g.* a fund) on the basis that profits of the person arose from (i) transactions ("**investment transactions**") falling within prescribed classes carried out through or arranged by firms licensed by the SFC, and (ii) transactions ("**incidental transactions**") incidental to the carrying out of the foregoing transactions.

A non-resident person which carried out transactions other than investment transactions or incidental transactions would lose exemptive relief if those transactions were carried out in the course of a business in Hong Kong. Trading receipts of a non-resident person from incidental transactions was capped at 5 per cent of total trading receipts from investment transactions.

Private Equity Concerns

There was some concern that whilst the 2006 tax changes were beneficial to hedge funds, they were insufficiently responsive to the needs of private equity.

First, though the prescribed classes of investments included shares and debentures of companies, shares or debentures of "a company that is a private company within the meaning of section 29 of the Companies Ordinance" were excluded. Some tax advisers believed that the exclusion included all private companies rather than just companies incorporated in Hong Kong under the Companies Ordinance. Obviously, such an interpretation would not be workable for private equity.

Secondly, advisers to private equity funds are not always licensed by the SFC. As the 2006 tax changes require that transactions be carried out through or be arranged by an SFC licensed firm, where the fund adviser is not licensed, a fund would only qualify for exemptive relief if an SFC licensed firm, such as investment bank, were engaged to carry out or arrange each portfolio transaction.

Protracted discussions took place with the Hong Kong government to address these concerns, culminating in the Inland Revenue (Amendment) (No. 2) Ordinance in 2015. This legislation made 2 key changes.

Qualifying Fund

First, it introduced the concept of a "qualifying fund". The concept provided an alternative to the requirement for investment transactions to be carried out through or to be arranged by an SFC licensed firm. In other words, exemptive relief could potentially be available either on the basis that (i) transactions in permissible asset classes were being carried out through or arranged by an SFC licensed firm for a non-resident fund, or (ii) the person carrying out transactions in permissible asset classes was a non-resident qualifying fund.

Qualifying funds are, in essence, funds that meet prescribed criteria aimed at ensuring they are *bona fide*. The criteria fall into 2 categories:

"The Hong Kong government proposes that exemptive relief will no longer be conditioned upon the existence of a non-resident fund. Under the proposal, relief will extend to any "collective investment scheme" as defined under the Securities and Futures Ordinance... which meets... prescribed criteria..."

- Genuine investor base – The number of investors following final closing must exceed 4 (*i.e.* 5 minimum investors) and capital commitments made by investors independent of the fund sponsor ("**originator**") and its affiliates must exceed 90 per cent. of aggregate capital commitments.
- Arm's Length Carried Interest – The agreed net proceeds (*i.e.* the value of all assets plus the sum of all distributions) arising out of transactions of the fund to be received by the originator and its associates must not exceed 30 per cent. of the net proceeds (excluding any net proceeds attributable to capital invested by the originator and its associates on the same basis as independent investors).

Special Purpose Vehicle and Excepted Private Company

The second key change made by the 2015 legislation was introducing the concepts of an "excepted private company" and a "special purpose vehicle".

An "**excepted private company**" refers broadly to portfolio companies but each such company must be incorporated outside of Hong Kong, must not issue shares or debentures to the public and must not in the 3 years prior to its disposal as a portfolio company have (i) carried on any business through or from a permanent establishment in Hong Kong, or (ii) held (directly or indirectly) share capital of any private company representing 10 per cent or more of its assets or held (directly or indirectly) immovable property representing 10 per cent or more of its assets.

A "**special purpose vehicle**" refers broadly to vehicles to hold portfolio companies but each such company must be incorporated outside of Hong Kong, must be wholly or partially owned by a non-resident fund and must be used solely to hold, directly or indirectly, portfolio companies. Special purpose vehicles cannot themselves be excepted private companies.

In broad terms:

- Any exemptive relief previously available to special purpose vehicles as non-resident persons carrying out investment transactions was taken away. In lieu, special purpose vehicles are exempt from profits tax on transactions in securities of an excepted private company (or a further special purpose vehicle) to the extent held by a non-resident fund which either (i) carries out investment transactions through an SFC licensed firm, or (ii) is a qualifying fund.
- By changing the definition of the prescribed classes of transactions eligible for relief, any exemptive relief for transactions by a fund in shares or debentures (or their prescribed derivatives) of a portfolio company was taken away unless the portfolio company qualifies as an excepted private company or is a public company (*i.e.* a company which can issue shares to the public).

Fund Level Proposals

The Hong Kong government now proposes that exemptive relief will no longer be conditioned upon the existence of a non-resident fund. Under the proposal, relief will instead extend to any "collective investment scheme" as defined under the Securities and Futures Ordinance ("**SFO**") which meets the following criteria:

- the scheme is not a business undertaking for general commercial or industrial purpose;

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- the scheme invests in permissible asset classes; and
- the scheme carries out or arranges its transactions through an SFC licensed firm or is a qualifying fund.

Collective Investment Scheme

The proposed shift to collective investment scheme terminology denies exemptive relief for certain persons now qualified for relief. This is because under the present language, though the stated intention is to exempt funds, relief technically applies to any "non-resident person". Whilst the term "collective investment scheme" is defined very broadly (and arguably, too broadly) under the SFO, obviously, it is no more than a subset of the term "person". As a result, non-resident persons will no longer qualify for exemptive relief if they fall outside the definition of a "collective investment scheme".

In this regard, the SFO definition of a "collective investment scheme" requires, amongst other things, that persons participating in the scheme do not have day-to-day control over the scheme's property. Accordingly, if adopted, the proposals would mean that non-resident proprietary trading entities (*e.g.* sovereign funds) may no longer qualify for relief.

The proposals are silent on the treatment of special purpose vehicles. It may be that these would qualify as "collective investment schemes" where a fund adviser exercises investment discretion and otherwise manages them.

Hong Kong Residency

The proposed removal of the non-residency requirements widens the availability of exemptive relief and is expected to result overall in greater accessibility of relief in that Hong Kong resident funds will now qualify for relief. As residency is, in the case of a corporation or partnership, defined by reference to the location of central management and control, the proposal will mean that it will now be possible for the board of directors of a fund or the general partner of a limited partnership to meet and otherwise conduct its business in Hong Kong without loss of relief.

This is a welcome change. There seems to be little reason to support an offshore industry the raison d'être of which is and has been to move out of Hong Kong the central management and control of funds otherwise sponsored from Hong Kong.

Portfolio Level Proposals

The Hong Kong government proposes to expand the current scope of the prescribed classes of transactions. The precise scope of the proposal is unclear. Whilst the government proposal paper suggests that excepted private companies will be permitted to invest in "any type of asset in Hong Kong", the paper goes on to list a number of provisos:

- Exemptive relief will only be available if such private companies meet the condition ("**No Hong Kong Real Estate Condition**") that they do not hold (directly or indirectly) more than 10 per cent of their assets in immovable property in Hong Kong or in one or more private companies with direct or indirect holdings in immoveable property.
- Exemptive relief will only be available for private companies which satisfy the No Hong Kong Real Estate Condition if such companies meet the condition ("**Minimum Holding Period Condition**") that they have been held by the fund for a minimum

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period of time, possibly 5 years or more.

- Exemptive relief will only be available for private companies which fail to satisfy the Minimum Holding Period Condition if such companies meet the condition ("**Short-Term Asset Ceiling**") that they hold no more than 50 per cent. of the value of their assets in "short-term assets". In this regard, it is proposed that "short-term assets" be defined as assets which (i) are neither prescribed assets such as securities, futures and currencies nor immoveable property in Hong Kong and (ii) have been held for less than 3 years before the date of disposal.

Though the language is uncertain, it is possible that the intention is to deny exemptive relief for private equity investments directly or indirectly in Hong Kong real estate (consistent with the No Hong Kong Real Estate Condition) and for all other assets:

- to offer exemptive relief for investments without restriction if they fall into prescribed classes (*e.g* securities, futures and currencies); and
- to offer exemptive relief for investments otherwise than in prescribed classes subject to either the Minimum Holding Period Condition or the Short-Term Asset Ceiling.

Significantly, the proposal suggests that where investments do not qualify for exemptive relief, only the profits from those investments will be subject to profits tax. In contrast, at present, where investments are neither transactions in prescribed classes nor transactions incidental thereto, exemptive relief will be lost for all profits of the non-resident person (*i.e.* the fund).

The absence of so-called tainting of the fund as a whole will enable fund advisers to consciously elect to make an investment or exit early from an investment without complying with the Minimum Holding Period Condition or the Short-Term Asset Ceiling knowing that such an election will not result in profits tax liability for unrelated portfolio transactions. Thus, for example, where a fund invests in Hong Kong real estate, it would be subject to profits tax on the disposal of that investment but would still be eligible potentially for relief from profits tax on transactions in public market securities.

Round Tripping

The proposals aim to keep the current round tripping provisions unchanged. Under these provisions:

- Where a resident person, either alone or jointly with any of his associates, holds or is interested in not less than 30 per cent of the issued share capital of a non-resident corporation or 30 per cent. of the profits of a non-resident partnership (not being a special purpose vehicle) (*e.g.* a non-resident fund) that is exempt from profits tax, a mathematical proportion of the assessable profits of the non-resident corporation or partnership attributable to the resident person are to be regarded as the assessable profits arising in or derived from Hong Kong of the resident person from a business carried on by the resident person in Hong Kong. The legislative intent is that a resident person who holds not less than 30 per cent. of a non-resident fund may be liable to profits tax on the profits of the non-resident fund.
- Where a resident person has a beneficial interest in a non-resident corporation or partnership (not being a special purpose vehicle) (*e.g.* a non-resident fund) that is exempt from profits tax and the resident

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person is an associate of the non-resident corporation or partnership, a mathematical proportion of the assessable profits of the non-resident corporation attributable to the resident person are to be regarded as the assessable profits arising in or derived from Hong Kong of the resident person from a business carried on by that resident person. The legislative intent is that a resident person who is an associate of a non-resident fund may be liable to profits tax on the profits of the non-resident fund if it holds an interest in the non-resident fund.

Equivalent provisions provide, in essence, for a resident person to be liable for profits tax on the profits of a special purpose vehicle which is held beneficially by a non-resident fund and which is exempt from tax from profits tax where either (i) the resident person holds not less than 30 per cent of the non-resident fund, or (ii) the resident person holds a beneficial interest in the non-resident fund and is an associate of the non-resident fund.

It is not clear how these round tripping provisions will operate where, as presently proposed, selected investments may be subject to profits tax. Presumably, round tripping provisions will only impose profits tax liability on a resident person from a given investment to the extent profit from the investment is itself exempt from profits tax.

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