

Tax Exemption for Open-Ended Fund Companies

Hong Kong's new open-ended fund companies ("OFCs") can qualify for exemption from profits tax in a number of ways including through the offshore funds tax exemption now used by traditional Cayman funds as well as the OFC specific tax exemption introduced in tandem with the introduction of the enabling legislation for OFCs. Although many market participants have shied away from OFCs believing that they can only rely upon the OFC specific tax exemption (which many regard as challenging), this is not the case. Rather than being limited to one exemption, OFCs have access to multiple exemptions. As a result, from a tax perspective, they in fact offer more flexibility for tax relief than Cayman funds including the possibility of tax exemption both as an offshore fund or as an onshore fund.

Since we published our article, "[Open-Ended Fund Companies: Are They Right for Hedge Funds?](#)", we have received a number of comments (wrongly) premised on the belief that it is difficult for open-ended fund companies ("OFCs") to qualify for exemption from Hong Kong profits tax. This belief is misplaced.

The Inland Revenue Ordinance ("IRO") contains multiple exemptions for investment funds. These exemptions offer different options for relief from Hong Kong profits tax. In common parlance, asset managers are free to select the exemption which best suits their needs from a menu of different exemptions. Rather than having fewer options for relief than Cayman funds, OFCs have more options.

Offshore Funds Exemption

One well known exemption from profits tax is the offshore funds exemption. This exemption is now widely used for hedge funds and private equity funds. Though the exemption has frequently been used for funds established in the Cayman Islands, the exemption is

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indifferent to where a fund is established. It applies equally to a fund registered in Hong Kong as it does to a fund registered in the Cayman Islands.

In broad terms, the exemption applies to any “non-resident person” in respect of profits from qualifying transactions, meaning transactions falling within prescribed asset classes carried out through or arranged by a person licensed by the Securities and Futures Commission (“SFC”) (and transactions incidental thereto). OFCs designed as hedge funds will normally have no difficulty meeting the requirement for such qualifying transactions as the prescribed asset classes include the type of assets in which hedge funds normally invest and all OFCs must be managed by a manager licensed by the SFC for Type 9 (asset management) regulated activity.

Whether an OFC can qualify as a “non-resident” person will depend upon the location of its central management and control. Central management and control is different from both the place of incorporation and the place where investment decisions are made. Equally, it is different from the place where the directors are resident. Central management and control refers to the highest level of control of a company and where a company exercises central management and control through the board, central management and control will rest where the board conducts its activities.

Just as Cayman funds make investment decisions in Hong Kong but undertake board activities outside of Hong Kong to obtain relief from profits tax, so too can OFCs.

Authorized Funds Exemption

Another well known exemption from profits is the exemption for SFC authorized funds. Under this exemption, a mutual fund or unit trust that is authorized by the SFC as a collective investment scheme is eligible for relief from profits tax if the scheme is carried on for the purposes set out in constitutive documents approved by the SFC and in accordance with the requirements of the Code on Unit Trusts and Mutual Funds (“**Mutual Fund Code**”). OFCs which are authorized by the SFC under the Mutual Fund Code are eligible for relief from profits just like any other SFC authorized fund. The fact that the fund being authorized by the SFC takes the form of an OFC rather than say, a Luxembourg SICAV or an Irish OEIC, does not deprive the fund of eligibility for this exemption.

OFC Tax Exemption

This brings us back to the exemption which the Hong Kong government crafted specifically for OFCs. The exemption should be regarded not as an exclusive means for OFCs to obtain relief but as an additional means for OFCs alone to obtain relief. Non-OFCs cannot benefit from this exemption and thus, OFCs in fact have a wider range of exemptive relief available to them than other types of funds though arguably, whether or not they seek to rely upon the OFC specific exemption, given the drafting of the IRO, there is the possibility that the IRO will impose upon them investment restrictions similar to those for private OFCs as set out in the Code on OFC. For funds investing in public securities, futures contracts

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and foreign exchange, these restrictions should pose no difficulties.

As a result, OFCs may choose to use the OFC specific exemption if they choose to locate their central management and control in Hong Kong rather than outside of Hong Kong. In this case, they will, amongst other things, need to raise and keep a minimum of HK\$200 million in assets under management. On the other hand, if OFCs choose to locate their central management and control outside of Hong Kong, they can rely instead upon the offshore funds tax exemption.

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About the Authors

TIMOTHY LOH LLP is an internationally recognized Hong Kong law firm focused on mergers & acquisitions, litigation and general financial markets and financial services matters. The firm is a leader in banking, financial regulation, corporate finance, capital markets and investment funds as measured by its rankings and those of its lawyers in leading independent editorial publications. The firm routinely acts for Fortune Global 500 companies.

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