Legislative proposal to grant profits tax exemption to resident, privately-offered open-ended fund companies

Last Wednesday, the Government introduced to the Legislative Council the Inland Revenue (Amendment) (No. 4) Bill 2017 (the Bill) that seeks to grant a profits tax exemption to resident, private-offered open-ended fund companies (OFCs) 1.

The tax alert summarizes the key provisions of the Bill. Clients who have any views or comments on the Bill can contact their EY tax adviser in Hong Kong so that we can convey their thoughts to the Government in an appropriate manner.

Background

Prior to the enactment of the Securities and Futures (Amendment) Ordinance 2016 (the New Law) in June last year, an open-ended investment fund could only be established under the laws of Hong Kong in the form of a unit trust, but not in a corporate form due to various restrictions under the Companies Ordinance as regards capital reduction.

In response to the market need for a more flexible choice of investment fund vehicle, the New Law provides that a fund can now be set up in the form of a corporation in Hong Kong with the added flexibility to vary its share capital. Such flexibility is needed in order to meet shareholder subscription and redemption requests arising by way of a fund being a collective investment scheme.

Under the existing profits tax exemption regime for funds, where a fund is an authorized fund [i.e., authorization has been obtained from the Securities and Futures Commission (SFC) or an equivalent overseas regulatory authority for the fund to be sold to the public in Hong Kong], it would be exempt from profits tax in Hong Kong pursuant to section 26A(1A) of the Inland Revenue Ordinance (IRO). This would be the case regardless of whether the central management and control of such a fund were exercised in Hong Kong or not (i.e., regardless of whether the said fund was a Hong Kong resident or not).

Where a fund is not an authorized fund, it will only be exempt from profits tax in Hong Kong if it is a non-Hong Kong resident and satisfies the exemption conditions specified under section 20AC of the IRO.

To encourage more funds to adopt the OFC structure, the Government has now introduced the Bill proposing to grant a profits tax exemption to resident, privately-offered OFCs established under the New Law.

Unless otherwise stated, all the references to “OFCs” below are references to privately-offered OFCs.

Key provisions of the Bill

Exemption conditions

The Bill provides that if all the following conditions are satisfied, an OFC is exempt from tax in Hong Kong in respect of its assessable profits derived from qualifying transactions and transactions incidental thereto.

Income from both qualifying transactions and transactions incidental thereto will be exempt if the latter does not exceed 5% of the total. Otherwise, the incidental income will be chargeable to tax in Hong Kong, but income from qualifying transactions will remain exempt.

Condition 1: The OFC is a Hong Kong resident person

The OFC must be a resident person with its central management and control exercised in Hong Kong (i.e., an onshore OFC).

Condition 2: The OFC is non-closely held (NCH)

Subject to certain safe-harbor rules2, an OFC is NCH if it satisfies the below ownership requirements:

a) where there is no qualified investor3, the OFC must have at least 10 investors4, the participation interest of at least 10 of such investors exceeding HK$20 million each; where there are one or more qualified investors, the OFC must have at least 5 investors4, the participation interest of at least 4 of the non-qualified investors exceeding HK$20 million each;

b) the participation interest of each qualified investor exceeds HK$200 million;

c) the participation interest of each investor (not being a qualified investor) does not exceed 50% of the OFC’s issued share capital; and

d) the participation interest of the originators and their associates does not exceed 30% of the OFC’s issued share capital.

In addition, the fund documents must state the intended NCH objective of the OFC and specify the intended categories of investors. Also, the terms and conditions governing participation in the fund cannot have the practical effect of being able to undermine the said NCH objective.

2. Safe-harbor rules generally refer to the discretionary power of the Commissioner of Inland Revenue to deem or regard the necessary exemption conditions or the 10% de minimis limit to have been satisfied under certain criteria.

3. Qualified investors generally refer to institutional investors such as organizations established for non-profit-making purposes, pension funds, publicly offered funds or government entities.

4. Such investors should not be the originator or its associates.
Condition 3: The OFC must only carry out qualifying transactions

Subject to the 10% de minimis limit and safe-harbor rules, the OFC must only carry out transactions in permissible asset classes (qualifying transactions) as specified in the proposed Schedule 16A to the IRO. This investment scope, which would be in alignment with the OFC code to be specified by the SFC, includes transactions in “securities”, “futures contracts”, “foreign exchange contracts”, “deposits”, “foreign currencies”, “certificates of deposit”, “cash” and “OTC derivative products”.

It should be noted that profits derived from transactions in non-permissible asset classes will in any case be subject to Hong Kong profits tax under the normal rules. However, where the 10% threshold is exceeded, the OFC would not be eligible for the proposed tax exemption. As such, any Hong Kong sourced trading profits derived by the OFC from qualifying (and incidental) transactions will be fully chargeable to profits tax in Hong Kong.

Condition 4: Qualifying transactions must be carried out through or arranged by a specified person

The relevant qualifying transactions have to be carried out or arranged in Hong Kong through or by a specified person, i.e., those persons who are licensed or authorized to conduct Type 9 regulated activities under the Securities and Futures Ordinance.

Rules that deem OFCs to be NCH for up to an initial 24-month period

Recognizing that an OFC may require some time in order to solicit the necessary number of investors, the Bill proposes that an OFC would in any case be deemed or “regarded” as NCH for up to an initial 24-month period (i.e., from the time it accepts its first investor), even if it fails to satisfy the NCH conditions within the aforesaid period.

To prevent possible abuse of this legislative provision by persons who may engage in arrangements involving repeatedly opening and closing of an OFC every 24 months, the Bill provides that the tax exemption previously granted to an OFC will be withdrawn under the following circumstances:

i. If an OFC is tax-exempt because it is “regarded” as NCH, and the OFC has not actually become NCH within 24 months after the day on which it accepts its first investor;

ii. If an OFC is tax-exempt because it is “regarded” as NCH and has subsequently become NCH (the qualifying event), the OFC ceases to carry on a trade, profession or business in Hong Kong, or ceases to be NCH within 24 months after the qualifying event; or

iii. If an OFC is exempt because it is NCH (the material event), the OFC ceases to carry on a trade, profession or business in Hong Kong, or ceases to be NCH within 24 months after the material event.

Specific anti-avoidance provision applicable to carried interest

The Bill contains a provision whereby remuneration and performance fees received by any person in respect of fund management services provided to an OFC in Hong Kong, albeit in the form of otherwise tax-exempt dividend from their shareholding in the OFC, would be chargeable to tax in Hong Kong.

Sub-fund of an umbrella OFC

The Bill proposes to amend the IRO to deem each sub-fund of an umbrella OFC to be an individual OFC as regards the proposed tax exemption status and the utilization of tax losses of the sub-fund concerned.

Deeming provisions that would render resident investors of an OFC chargeable to tax in Hong Kong under certain conditions

To prevent resident persons taking advantage of the proposed profits tax exemption for OFCs, the Bill contains deeming provisions similar to those applicable to resident persons having a beneficial interest in a tax-exempt non-resident fund.

Under the proposed deeming provisions, if a Hong Kong resident investor holds a 30% or more beneficial interest in a tax-exempt OFC, or any percentage if such Hong Kong resident investor is associated with the tax-exempt OFC, the said Hong Kong resident investor will be deemed to have derived the underlying profits of the tax-exempt OFC. Furthermore, the Hong Kong resident investor will be chargeable to tax in Hong Kong for the year in question, regardless of whether they have received the deemed profit concerned.

Limitation of losses

Where relevant exemption conditions are satisfied, profits derived from qualifying (and incidental) transactions are exempt from tax in Hong Kong. As a matter of symmetry, the Bill provides that losses sustained by a tax-exempt OFC in the same set of circumstances from qualifying (and incidental) transactions in a year of assessment would not be available for offset against any of its assessable profits for any subsequent years of assessment.

The Bill also contains provisions that ring-fence the tax losses sustained by an OFC such that tax losses sustained by the OFC from its qualifying (and incidental) transactions and non-qualifying transactions cannot be cross-utilized.
Commentary

We welcome the proposed legislation as it will help attract privately-offered OFCs to domicile in Hong Kong, thereby generating demand for related legal, accounting and fund management services in Hong Kong. The availability of OFCs in Hong Kong would further strengthen Hong Kong’s position as an international asset management centre and enhance the offerings that Hong Kong’s financial services industry can provide.

As regards certain detailed provisions of the Bill, it is however unclear why the NCH requirement is necessary for the proposed profits tax exemption for OFCs, given that there is no such NCH requirement for the tax exemption for non-resident funds. This is particularly the case given that there is already a deeming provision whereby resident investors would be deemed to have derived the underlying profits of a tax-exempt OFC under certain conditions, and be taxed accordingly.

The Government indicates that a qualified investor would normally be required to invest a substantial stake of more than HK$200 million such that the operation of the fund would not be affected by the mobility of other smaller investors. Even so, once the first qualified investor is secured, other subsequent qualified investors may not be required to invest a substantial stake in the fund. As such, the requirement specified in the Bill that the investment sum of each qualified investor of an OFC must exceed HK$200 million may be difficult to achieve in some cases.

Furthermore, the minimum number (4 or 10 as the case may be) of ordinary investors that are required to invest more than HK$20 million in an OFC appears to be on the high side.

The Bill also marks, for the first time, the introduction of a specific anti-avoidance provision for carried interest. Coupled with earlier indications by the Inland Revenue Department (IRD) in its practice note that it may challenge carried interest arrangements adopted by certain offshore funds under the general anti-avoidance provision, the introduction of a specific anti-avoidance provision illustrates the IRD’s determination to tax carried interest in appropriate circumstances. As such, clients should review whether their current tax filing position in respect of carried interest is justified.

Clients who have any views or comments on the Bill can contact their EY tax adviser in Hong Kong so that we can convey their thoughts to the Government in an appropriate manner.
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