

Hong Kong Tax Alert

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Hong Kong passes new law to grant profits tax exemption to all privately-offered funds in the form of collective investment schemes

On 20 February 2019, the legislative bill which granted profits tax exemption to all privately-offered funds was passed by the Legislative Council in its original form without any amendment. The new law will be effective for transactions occurring on or after 1 April 2019.

This alert summarizes the new law and discusses clarifications the Government provided on certain provisions of the new law during the legislative process.

Notwithstanding the clarifications, many of the provisions of the new law are complicated. The Inland Revenue Department (IRD) has undertaken to issue a practice note at a suitable time to elaborate on its interpretation and assessing practices in respect of the new law.

In the meantime, clients who wish to explore how they can benefit from the new law can contact their tax executives.

The new law

Under the new law, regardless of their residence, funds in the form of collective investment schemes will be exempt from profits tax in Hong Kong in respect of their usual investment and securities trading income, provided that the transactions are carried out by a specified person, or the fund itself is a qualified investment fund.

Profits tax exemption in respect of investment in both overseas and Hong Kong incorporated private companies by a fund or a special purpose entity (SPE) owned by such a fund will only be available subject to satisfying certain additional conditions.

Importantly, the new law will not contain any tainting provisions. This means, a fund will not lose its tax exemption status but will only be taxable in respect of profits from non-qualifying transactions that are onshore sourced and revenue in nature.

The current exemption regime for non-resident persons will remain intact such that non-resident persons, which do not qualify as funds under the new law, will still enjoy tax exemption under that separate regime, provided that the relevant exemption conditions are met.

Clients who would like to understand the detailed provisions of the new law may also refer to our Hong Kong tax alert issued on 10 December 2018 (2018 Issue No. 17).

Clarifications of certain provisions of the new law

During the legislative process of the new law, several professional bodies and business organizations made submissions to the Bills Committee that was formed by the Legislative Council to scrutinize the bill.

Some of the concerns raised in these submissions, and the Government's response and clarifications to the same are discussed below.

A bona fide fund may only have one investor at a certain point in time

Under the new law, one of the necessary conditions for qualifying as a "fund" is that the arrangement involved must pool the contributions of persons (participating persons) participating in the said arrangement.

Some submissions noted that at the initial stage of launching a fund, there may only be one person providing the seed capital of the fund before the fund can attract further investors. There was concern that such a fund at its initial stage may not be able to enjoy the tax exemption under the new law.

In response, the Government clarified that according to the Interpretation and General Clauses Ordinance, the plural includes the singular. As such, the term "participating persons" would not necessarily prevent a bona fide fund from enjoying the tax exemption, even though it only has one investor at a certain point in time.

No relaxation of what an SPE can perform

While the new law provides that tax exemption will apply at both the fund and SPE level, the permitted scope of activities that an SPE can undertake is more restrictive than that of a fund. The only role that can be played by an SPE is limited to holding and administering investee private companies, and is prohibited from making investment in any other qualifying assets.

Some submissions requested the Government to align the scope of activities of an SPE that is wholly-owned by a fund with that of the fund.

The Government rejected these submissions and maintained its view that an SPE should be established solely for the purpose of holding and administering investee private companies. Otherwise, entities which are not really SPE could inadvertently be covered by the tax exemption under the new law.

The term "met in good faith" is similar to "bona fide"

Under the new law, profits derived from the disposal of private companies will be taxed unless certain specified conditions can be met by a fund or an SPE "in good faith". The imposition of the specified conditions is to safeguard against potential abuse of the new law. Otherwise, a fund or an SPE can employ a private company to acquire non-qualifying assets (profits from the direct trading of which will be chargeable to tax) and then dispose the private company concerned, thereby qualifying for the tax exemption.

However, as the term "met in good faith" is not defined in the Bill, there was concern that this would confer great discretionary power on the Commissioner in determining whether a fund or an SPE would be able to enjoy tax exemption and thus give rise to uncertainty.

The Government explained that the phrase "in good faith" is intended to guard against notional but not genuine compliance of the specified conditions. Similar wording can be found in other provisions of the existing tax law, such as section 26A(1A)(a)(ii), where the term "bona fide" is used in relation to profits tax exemption for publicly offered funds. The Government added that the IRD will take into consideration all relevant factors in determining whether a fund or an SPE is acting in good faith.

Making the “holding of debt securities to earn interest” as a qualifying transaction not considered this time

Under the new law, the list of qualifying transactions does not include “the holding of debentures, loan stocks, bonds or notes to earn interest income”. As such, interest income derived by funds from the holding of such debt instruments would only be regarded as income incidental to the qualifying transactions of buying and selling of the instruments concerned.

The tax exemption of such incidental interest income will however be subject to the 5% threshold. That means, where the interest income exceeds 5% of the total trading receipts of the fund for a year, the interest income, if sourced in Hong Kong, will be fully taxable in Hong Kong.

As such, bond funds may not benefit from the new law given that their principal income is frequently interest which could easily exceed 5% of their total trading receipts for a year.

Given the increasing popularity of many bond funds to investors, there were submissions requesting the Government to include “the holding of debentures, loan stocks, bonds or notes to earn interest income” as qualifying transactions.

The Government did not however accept these submissions and reasoned that the request would have wide implications on Hong Kong’s tax policy and is outside the scope of this legislative exercise.

Hong Kong office

Agnes Chan, Managing Partner, Hong Kong & Macau
22/F, CITIC Tower, 1 Tim Mei Avenue, Central, Hong Kong
Tel: +852 2846 9888 / Fax: +852 2868 4432

Jim Hunter
Asia-Pacific Tax Leader
+852 2849 9338
jim.hunter@hk.ey.com

Ian McNeill
Asia-Pacific Financial Services Tax Leader
+852 2849 9568
ian.mcneill@hk.ey.com

Non-financial Services

David Chan
Tax Leader for Hong Kong and Macau
+852 2629 3228
david.chan@hk.ey.com

Business Tax Services

Hong Kong Tax Services

Agnes Chan
+852 2846 9921
agnes.chan@hk.ey.com

Wilson Cheng
+852 2846 9066
wilson.cheng@hk.ey.com

Tracy Ho
+852 2846 9065
tracy.ho@hk.ey.com

Chee Weng Lee
+852 2629 3803
chee-weng.lee@hk.ey.com

May Leung
+852 2629 3089
may.leung@hk.ey.com

Grace Tang
+852 2846 9889
grace.tang@hk.ey.com

Karina Wong
+852 2849 9175
karina.wong@hk.ey.com

Jo An Yee
+852 2846 9710
jo-an.yee@hk.ey.com

China Tax Services

Ivan Chan
+852 2629 3828
ivan.chan@hk.ey.com

Lorraine Cheung
+852 2849 9356
lorraine.cheung@hk.ey.com

Becky Lai
+852 2629 3188
becky.lai@hk.ey.com

Carol Liu
+852 2629 3788
carol.liu@hk.ey.com

Tax Technology and Transformation Services

Albert Lee
+852 2629 3318
albert.lee@hk.ey.com

Indirect Tax Services

Andy Leung
+852 2629 3299
andy-sy.leung@cn.ey.com

International Tax Services

Alice Chan-Loeb
+852 2629 3882
alice.chan@hk.ey.com

Cherry Lam
+852 2849 9563
cherry-lw.lam@hk.ey.com

Jeroen van Mourik
+852 2846 9788
jeroen.van.mourik@hk.ey.com

Martin Richter
+852 2629 3938
martin.richter@hk.ey.com

Aaron Topol
+852 2675 2980
aaron.topol@hk.ey.com

Kenny Wei
+852 2629 3941
kenny.wei@hk.ey.com

People Advisory Services

Ami Cheung
+852 2629 3286
ami-km.cheung@hk.ey.com

Robin Choi
+852 2629 3813
robin.choi@hk.ey.com

Jeff Tang
+852 2515 4168
jeff.tk.tang@hk.ey.com

Paul Wen
+852 2629 3876
paul.wen@hk.ey.com

Transaction Tax Services

David Chan
+852 2629 3228
david.chan@hk.ey.com

Jane Hui
+852 2629 3836
jane.hui@hk.ey.com

Tami Tsang
+852 2849 9417
tami.tsang@hk.ey.com

Eric Lam
+852 2846 9946
eric-yh.lam@hk.ey.com

Financial Services

Paul Ho
Tax Leader for Hong Kong
+852 2849 9564
paul.ho@hk.ey.com

Business Tax Services

Florence Chan
+852 2849 9228
florence.chan@hk.ey.com

Sunny Liu
+852 2846 9883
sunny.liu@hk.ey.com

Global Compliance and Reporting

Michael Stenske
+852 2629 3058
michael.stenske@hk.ey.com

International Tax Services

James Badenach
+852 2629 3988
james.badenach@hk.ey.com

Jacqueline Bennett
+852 2849 9288
jacqueline.bennett@hk.ey.com

Justin Kyte
+852 2629 3880
justin.kyte@hk.ey.com

Adam Williams
+852 2849 9589
adam-b.williams@hk.ey.com

Transaction Tax Services

Rohit Narula
+852 2629 3549
rohit.narula@hk.ey.com

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