



## Hong Kong Tax Newsflash: Discussion Paper on the Legislative Proposal on Tax Exemption for Investment Funds

The HKSAR government is proposing legislative amendments to introduce a tax exemption for funds managed in Hong Kong (Legislative Proposal), and has prepared a paper ([LegCo Paper](#)) to brief the Panel on Financial Affairs of the Legislative Council on the proposal. The panel meeting was held on 5 November 2018.

### Background

Under the Inland Revenue Ordinance, there is a specific tax exemption provided to privately offered offshore funds given certain conditions are met (Existing Regime). However, the Council of the European Union (EU) has identified the Existing Regime as containing ring-fencing features<sup>1</sup>, which are key factors for identifying harmful tax practices. The EU considers the Existing Regime to be ring-fenced from the domestic economy both at the fund level and the investment level for the following reasons:

- Only offshore funds, but not onshore funds<sup>2</sup>, are entitled to the profits tax exemption; and
- Offshore funds that invest in a private company incorporated and operating outside Hong Kong generally can qualify for the tax exemption, but offshore funds investing in a private operating company that is incorporated in Hong Kong<sup>3</sup> does not qualify for the exemption. For details, see Deloitte's [Tax Analysis \(Issue H63/2015\)](#) published on 12 May 2015 and [Tax Newsflash \(Issue 29\)](#) published on 17 July 2015.

To address the EU's concerns about ring-fencing and to prevent Hong Kong from being added to the EU's black list of noncooperative jurisdictions and exposed to defensive measures, the HKSAR government, after industry consultation, issued the LegCo Paper with a view to amending the tax exemption regime for funds (New Regime).

## Key Features of the Legislative Proposal

### Removal of ring-fencing at the fund level

A "fund" meeting the relevant definition under the New Regime would be entitled to enjoy the profits tax exemption, regardless of its structure, size, location of its central management and control, etc., if certain conditions are fulfilled. The definition of a fund for these purposes is expected to be similar to the definition of a "collective investment scheme" in Part 1 of Schedule 1 to the Securities and Futures Ordinance (SFO), with appropriate modifications. To prevent abusive structures, it is proposed that a business undertaking for general commercial or industrial purpose would not be considered a fund under the New Regime. For example, the following, among others, would not fall within the scope of a fund:

- A commercial activity involving the purchase, sale and/or exchange of goods or commodities, and/or supply of services;
- An industrial activity involving the production of goods or construction of property; and
- Making direct investments that derive rent, royalties or lease payments.

### Removal of ring-fencing at the investment level

Under the New Regime, a fund's transactions in "qualifying assets"<sup>4</sup> would qualify for the profits tax exemption if the relevant conditions are satisfied.

The proposed list of qualifying assets covers relevant interests in or issued by a private company (regardless of whether the company is incorporated in Hong Kong). However, a fund would not qualify for a profits tax exemption from an investment in a private company, unless the following tests (Private Company Tests) are met:

- **Hong Kong immovable property test** – The private company does not hold directly or indirectly more than 10% of its assets in immovable property (excluding infrastructure) in Hong Kong; **and**
- **Holding period test** – The investment in the private company has been held by the fund for at least two years; **or**
- **Short-term assets test** - If the holding period test is not satisfied, (i) the fund does not have a controlling stake in the private company; or (ii) where the fund has a controlling stake in the private company, the private company does not hold more than 50% of the value of its assets in short-term assets (i.e. assets, excluding

qualifying assets and immovable property in Hong Kong, held by the private company for less than three years at the time of the transaction)

### Removal of tainting features

It is proposed that, unlike the Existing Regime, there would be no tainting under the New Regime, i.e., the tax-exempt profits of the fund would not be tainted even if the fund is taxed on its other profits that are not tax-exempt.

### **Deloitte's Observations**

We welcome the Legislative Proposal, which should help to address the EU's concerns and also suggests a more unified and expanded funds tax exemption regime in Hong Kong. We believe the setting of a period of two years for the holding period test should receive positive feedback from the industry in general. However, there are still uncertainties surrounding the New Regime, and we expect more legal clarity particularly in relation to the following:

#### *Investment level - Use of special purpose entities (SPE)*

The LegCo Paper mentions that the profits tax exemption would apply at both the fund level, and if there is an SPE, at the SPE level to the extent it corresponds to the percentage of shares or interests held by the fund.

However, the LegCo Paper does not define an SPE. In this regard, we believe that the term should be defined in the draft bill to provide for a tax exemption to (i) an SPE disposing of its underlying SPE or portfolio company; and (ii) a fund disposing of its underlying SPE, provided the portfolio company satisfies the Private Company Tests as mentioned above. To ensure the attractiveness of the New Regime to the industry, the definition of SPE should not be overly restrictive/limited on the functions that a qualifying SPE can perform, such that it may be difficult for an SPE to obtain a Certificate of Resident Status in Hong Kong and at the same time qualify as an SPE for tax exemption under the New Regime. Meanwhile, an SPE, even with expanded functions, should retain its status as an "SPE" and should not be regarded as a "private company" for purposes of the New Regime in determining whether the profits tax exemption applies.

In view of the above, we expect to see more clarity in the draft bill regarding the application of the tax exemption in a structure involving the use of SPEs.

#### *Fund level - Definition of "fund"*

According to Part 1 of Schedule 1 to the SFO, a collective investment scheme, apart from the other features, is defined to mean an arrangement in respect of any property under which the "participating persons" do not have day-to-day control over the management of the property. It is not entirely clear whether this definition could encompass a fund in the form of a limited partnership (which is typical for a private equity fund). This is because the general partner of a limited partnership generally should be responsible for the ultimate management, control and decision-making in relation to the limited partnership, in which

it also may hold an interest (e.g. 1%) in the limited partnership. In such a case, it is unclear whether the general partner would be regarded as a participating person (given its holding of partnership interests) that has day-to-day control of the limited partnership, and hence disqualifying a limited partnership from meeting the definition of a fund if the meaning of a fund were to be taken too literally.

We expect more clarity regarding the interpretation of a collective investment scheme in this regard. According to the LegCo Paper, one objective is that a fund, regardless of its structure, generally should be able to enjoy the profits tax exemption. Hence, we believe that the definition of a fund should not be interpreted too narrowly, which may deprive a commonly used type/structure of fund from enjoying the tax exemption.

#### *Indirect transfer of Hong Kong immovable property and continuous application of general charging section*

The LegCo Paper mentions that if a fund invests in a private company that does not meet the Hong Kong immovable property test, the fund would be taxed on the profits arising from the investment in the private company. We expect a clarification that this only means that the fund would not qualify for the profits tax exemption in respect of such a "non-qualifying" transaction under the New Regime, but the transaction would not be deemed to be taxable, i.e. taxability would continue to be based on the general charging section under Hong Kong tax law. Under current law, even if the transaction does not qualify for a tax exemption, the gain is not taxable in Hong Kong if it is sourced outside Hong Kong and/or capital in nature. The taxability of any gains on a transaction in shares of a holding company depends on the source and/or nature (i.e. whether capital or revenue in nature) of the share transaction itself, and there is currently no specific legal provision in Hong Kong to deem the sale of shares in a holding company as taxable merely because of its underlying investment in Hong Kong immovable property. We believe that the New Regime is not intended to alter this position. The provision under the New Regime should be interpreted as an exemption provision, rather than a deeming provision, such that even the fund does not qualify for the tax exemption, it would not be taxed if it would not have been taxed under the general charging section.

### **Way Forward**

The HKSAR government plans to introduce the Legislative Proposal into the Legislative Council in December 2018, and hopefully more details and clarity will be provided when the draft bill is introduced. We expect that the Legislative Proposal will bring very positive changes to the tax environment of the funds industry in Hong Kong. Industry players should continue to monitor developments and seek professional advice on how the changes could impact their existing operations.

<sup>1</sup> Ring-fencing occurs where the preferential tax treatment is partially or fully isolated from the domestic economy.

<sup>2</sup> Except onshore privately offered open-ended fund companies for which there are separate profits tax exemption arrangements under the Inland Revenue (Amendment) (No. 2) Ordinance 2018.

<sup>3</sup> Except investee company under the Innovation and Technology Venture Fund (ITVF) Scheme, subject to certain conditions.

<sup>4</sup> The proposed list of qualifying assets in the LegCo Paper covers (a) securities; (b) shares, stock, debentures, loan stock, funds, bonds or notes of, or issued by, a private company (regardless of whether the company is incorporated in or outside Hong Kong); (c) futures contracts; (d) foreign exchange contracts; (e) deposits other than those made by way of a money-lending business; (f) bank deposits; (g) certificates of deposits; (h) exchange-traded commodities; (i) foreign currencies; (j) over-the-counter derivative products; and (k) shares of private companies co-invested by partner funds of the ITVF and the ITVF.

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