Bills Committee on Inland Revenue (Amendment) (No. 4) Bill 2017

Response to Follow-up Actions Arising from the Discussion at the Meeting on 20 July 2017

This paper sets out the Government's responses to the issues raised by Members in relation to the Inland Revenue (Amendment) (No. 4) Bill 2017 at the meeting of the Bills Committee on 20 July 2017.

(a) Eligibility conditions

2. We propose that an onshore privately offered open-ended fund company ("OFC") **(hereinafter referred to as "subject OFC")** should satisfy certain conditions for it to be able to enjoy profits tax exemption. The conditions seek to provide safeguards to prevent abuse. The rationale for imposing the following conditions is set out in paragraphs 3 to 5.

The OFC must be "non-closely held"

3. A subject OFC seeking profits tax exemption cannot be closely held. This aims to ensure that such an OFC is not owned by only a few individuals or corporate investors. Otherwise, an individual or a corporate investor who is carrying out securities transactions in Hong Kong and subject to profits tax may abuse the tax exemption by repackaging its business as a subject OFC. The details of the proposed "non-closely held" condition **(hereinafter referred to as "NCH condition")**, as well as our rationale behind the requirements under the NCH condition, are set out at **Annex**.

The OFC must invest in permissible asset classes specified by the Securities and Futures Commission ("SFC"), with a 10% de minimis limit for investment in non-permissible asset classes

4. As required under section 112Z of the Securities and Futures (Amendment) Ordinance 2016 ("the 2016 Amendment Ordinance") enacted by the Legislative Council ("LegCo") in June 2016 to provide for the legal framework for OFCs as a fund vehicle, an OFC to be set up under the Securities and Futures Ordinance (Cap. 571) ("SFO") should engage an investment manager licensed by or registered with the SFC to carry out Type 9 (asset management) regulated activity. Consequently, the investment scope of an OFC should align with such regulated activity. As stated in the LegCo Brief on the 2016 Amendment Ordinance (Ref:

SF&C/1/2/22C(2015)), the SFC will specify in its future OFC Code the asset classes in which privately offered OFCs may invest (i.e. mainly securities and futures), with a degree of flexibility by allowing a 10% *de minimis* limit for investing in other asset classes. In setting this limit, feedback received during the public consultation on the proposed OFC regime in 2014 has been taken into account. We propose extending the treatment when offering profits tax exemption for privately offered OFCs.

Transactions of the OFC must be carried out through or arranged by a qualified person

5. Following the requirement as stipulated under section 112Z of the 2016 Amendment Ordinance, we propose that the activities that produce the profits from the transactions must be carried out through or arranged in Hong Kong by corporations or authorised financial institutions licensed or registered under the SFO ("qualified persons") to carry out Type 9 (asset management) regulated activity. This is to ensure that a subject OFC enjoying tax exemption would have substantial activities in Hong Kong and contribute to Hong Kong's economy.

(b) Current taxation regime

6. Profits tax exemption is given under section 26A(1A) of the Inland Revenue Ordinance (Cap. 112) ("IRO") to publicly offered funds[1] (irrespective of the locality of their central management and control ("CMC")) authorised by the SFC under section 104 of the SFO or similar bona fide widely held investment schemes which comply with the requirements of a supervisory authority within an acceptable regulatory regime. Meanwhile, offshore funds[2] with their CMC outside Hong Kong (whether publicly or privately offered) are exempt from profits tax in respect of profits derived from specified transactions carried out through or arranged by specified persons. Given that publicly offered funds are regulated by the SFC and/or the regulator in their home jurisdictions, and that they are usually widely held by a large number of investors, it was considered that there would be a lower risk of the funds being used for tax abuse. As for offshore funds, the purpose of granting profits tax exemption to them is to help to attract new offshore funds to

---

[1] The tax exemption for publicly offered funds was first introduced in 1983 for unit trusts, 1990 for mutual funds, and 1996 for all types of publicly offered funds.

[2] The tax exemption for offshore funds was implemented in 2006 and was subsequently extended to offshore private equity funds in 2015.

Hong Kong and encourage existing offshore funds to continue to invest in Hong Kong. As explained in the LegCo Brief on the Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005 (Ref: FIN CR3/7/2201/02), the Government considered at the time that there was practical difficulty in effectively enforcing the relevant IRO provisions and recovering the tax in respect of cases where the persons carrying out securities transactions were non-residents outside the reach of legal action initiated in Hong Kong. The assessment was thus that the actual cost to revenue of the exemption should not be significant.

7. Over the years, we note that other major fund jurisdictions such as the UK and Singapore have been increasingly proactive in promoting the development of their onshore fund industry. For Hong Kong to remain competitive and be able to meet the development needs of the fund industry, we consider it appropriate to provide tax incentive arrangements for the subject OFCs. Yet, we are mindful that there could be a higher risk of tax abuse for onshore privately offered funds (residents may be able to convert their taxable profits into non-taxable income via such a fund structure more easily). Thus, in developing the tax incentive arrangements for the subject OFCs, we have carefully considered the need for anti-avoidance measures and put in place sufficient safeguards (such as those mentioned in paragraphs 3 to 5 above).

(c) Projection of financial and economic implications

8. Our proposal to grant tax exemption to the subject OFCs would be conducive to enhancing Hong Kong's competitiveness in respect of the domiciliation of privately offered OFCs, thereby generating demand for local asset management, investment and advisory services, as well as other relevant professional services. This would help strengthen Hong Kong's position as an international asset management centre and foster the further development of our financial services industry as a whole. This notwithstanding, as the decision with respect to fund domiciliation is essentially a commercial decision which depends on a number of factors, the Government cannot project the number of subject OFCs that will be established in Hong Kong or the number of jobs created by them. Meanwhile, the proposal should essentially **not** give rise to tax revenue loss given the lack of presence of the subject OFCs in Hong Kong so far.

(d) Taxation of carried interest

9. The Inland Revenue Department ("IRD") issued in May 2016 the Departmental Interpretation and Practice Notes ("DIPN") No. 51 on "Profits tax exemption for offshore private equity funds". In the DIPN, IRD provides explanations on, amongst other things, the taxation of investment managers. Such explanations are applicable to all types of fund structures, including limited partnerships, unit trusts, mutual funds and OFCs, whether onshore or offshore.

10. The principles on taxation of carried interest are as follows –

(a) investment managers or advisors should be adequately compensated for their professional services or remunerated on an arm's length basis[3];

(b) consideration or remuneration, including dividends or distributions, accrued to investment managers or advisors from professional services provided in the course of a trade or business carried on in Hong Kong to offshore or onshore funds should be chargeable to profits tax;

(c) remuneration, structured as a dividend or distribution, payable to fund executives from services rendered in Hong Kong would be chargeable to salaries tax as employment income or profits tax as service income; and

(d) dividends or distributions comparable to the return arising on investments made by external investors in a fund, and which are not derived from services rendered in the course of a trade or an employment, would not be subject to taxation.

To sum up, carried interest (unless comparable to the return arising on investments made by external investors in a fund) received by investment managers or advisors or fund executives in respect of their professional services provided in Hong Kong, as well as any subsequent income derived from the holding or disposal of such carried interest, will be subject to taxation.

---

[3] Meanwhile, such remuneration (e.g. management/performance fees) charged in the accounts of an OFC as an expense would be allowed for tax deduction to the extent that it has been incurred for producing chargeable profits.

11. Currently, section 26(a) of the IRO provides for profits tax exemption of dividends received from corporations which are chargeable to profits tax. As a subject OFC (which is a “corporation”) would be chargeable to tax in respect of profits derived from transactions in non-permissible asset classes, section 26(a) of the IRO will apply. Consequently, performance fees and carried interest paid out in the form of dividends to investment managers will be exempt from tax, when in fact such fees and interest are essentially income or profits derived from management services rendered in Hong Kong (and hence should be chargeable to tax based on the principles set out in the DIPN). We therefore propose to include an express provision (i.e. section 20AJ(3)) to ensure that consideration or remuneration received by a person for providing investment services, directly or indirectly, for the OFC in the course of a trade or business carried on in Hong Kong will be chargeable to profits tax so that IRD’s enforcement of the above-mentioned principles will not be hampered.

Financial Services and the Treasury Bureau
Inland Revenue Department
28 September 2017

<u>**Annex**</u>

Requirements under the "non-closely held" condition

An **onshore privately offered open-ended fund company (hereinafter referred to as "subject OFC")** will be regarded as "non-closely held" subject to fulfilling **the following requirements (hereinafter referred to as "NCH condition")** –

A. Ownership requirement

(a) at all times after the date on which an OFC meets the NCH condition or on expiry of the first 24 months after a subject OFC accepts its first investor, **where the OFC has one or more than one qualified investor** –

(i) the number of investors[1] in the OFC who are not the originator and the originator's associates is at least five;

(ii) the participation interest of a qualified investor in the OFC exceeds $200 million;

(iii) for at least four investors (not being qualified investors) in the OFC, the participation interest of each of them exceeds $20 million;

(iv) the participation interest of each investor (not being a qualified investor) does not exceed 50%; and

(v) the participation interest of the originator and the originator's associates in the OFC does not exceed 30%;

(b) at all times after the date on which an OFC meets the NCH condition or on expiry of the first 24 months after a subject OFC accepts its first investor, **where the OFC has no qualified investor** –

[1] An investor in a subject OFC can be a natural person or a person as defined in the Inland Revenue Ordinance (Cap.112) (which includes "a corporation, partnership, trustee, whether incorporated or unincorporated, or body of persons"). An investor does not include the originator and its associates.

(i) the number of investors in the OFC who are not the originator and the originator's associates is at least ten;

(ii) for at least ten investors in the OFC, the participation interest of each of them exceeds $20 million;

(iii) the participation interest of each investor does not exceed 50%; and

(iv) the participation interest of the originator and the originator's associates in the OFC does not exceed 30%.

A "qualified investor" means certain specified types of institutional investors, which typically have a large number of underlying investors. They include organisations established for non-profit-making purposes, pension funds, publicly offered funds and governmental entities. As it takes time for a fund to establish a track record and attract investors, we propose to allow a maximum of 24 months for a subject OFC to meet the NCH condition, i.e. such OFC can enjoy profits tax exemption in its 24-month start-up period after it accepts its first investor even if it cannot yet meet the NCH condition.

B. Fund document requirement

(c) at all times the fund documents –

(i) contain a statement that shares in the subject OFC will not be closely held; and

(ii) specify the intended categories of investors;

C. Terms and conditions requirement

(d) at all times neither –

(i) the specification of the intended categories of investors; nor

(ii) any other terms or conditions governing participation in the fund, whether or not specified in the fund documents;

have a limiting or deterring effect .

2. In coming up with the criteria for the ownership requirement under section A above, we have taken into account –

(a) empirical data provided by the industry on fund size vis-à-vis number of investors. Generally speaking, the number of investors would go up as assets under management ("AUM") in a fund increase. It is quite common for funds with AUM below $390 million (or US$50 million) to have about five investors and for those with AUM between $390 million and $780 million (or between US$50 million and $100 million) to have around ten investors. We have therefore adopted "five" and "ten", depending on whether there is any "qualified investor", as the minimum number of investors that a subject OFC, which should not be held (and hence controlled) by a small number of investors, should have in order for it to be eligible for the profits tax exemption;

(b) industry feedback suggests that institutional investors prefer to hold a substantial stake in a fund so that it would not be easily affected by the mobility of small investors. Thus, when there is a qualified investor in a subject OFC, we reckon that it would prefer holding at least 50% participation interest. According to industry data, a qualified investor should hence be required to invest at least $200 million (roughly equals to $390 million (fund size mentioned in (a) above) × 50%). This should also help ensure that a subject OFC is of a reasonably large fund size; and

(c) to ensure that a subject OFC is not held (and hence controlled) by a small number of investors, we will not allow any non-qualified investor to hold a particularly large stake of the OFC. Hence, the participation rate of any non-qualified investor should not exceed 50% and that of the originator and its associates should not exceed 30%. Meanwhile, the participation interest of a non-qualified investor should exceed \$20 million (roughly equals \$780 million (fund size mentioned in (a) above) × 20% ÷ 9 investors).

3. The purposes of the three requirements under sections A to C above are as follows –

(a) **A subject OFC is required to satisfy the NCH condition at all times after the date on which an OFC meets the NCH condition or on expiry of the first 24 months after the OFC accepts its first investor** (section A above). This is to ensure that a subject OFC is non-closely held continuously throughout the life of the fund. In view that an OFC may take some time to invite subscriptions from investors to meet the NCH condition, a subject OFC can have a maximum of 24 months (counting from the date that it accepts its first investor) to meet the NCH condition.

(b) **It must have a minimum number of investors** (section A above) so that a tax-exempt subject OFC would not be held (and hence controlled) by a small number of investors.

(c) **The participation interests of various types of investors must meet relevant percentage caps and levels** (section A above). The purpose of the percentage cap of different types of investors is to ensure that a tax-exempt subject OFC is not controlled by a small number of investors or by the originator and the originators' associates. Meanwhile, the minimum participation interest of different types of investors in terms of amount is to prevent persons acting in concert by investing only a minimal sum and to ensure that a tax-exempt fund has a reasonably large fund size.

(d) A subject OFC complying with the NCH condition should also meet the **fund document requirement** (section B) and **terms and conditions requirement** (section C). Privately offered funds normally target specific categories of investors. These requirements aim to ensure that the fund documents reflect that the subject OFC is non-closely held, and to exclude from tax exemption OFCs which are available only to specific individuals or corporate investors, whether such limitation is achieved by a specific rule set out in the fund documents or by the imposition of terms and conditions that would have the effect of deterring investors from investing in the fund.