LC Paper No. CB(1)660/16-17(04)

For discussion
on 16 March 2017

Legislative Council Panel on Financial Affairs

Proposed Extension of Profits Tax Exemption to Onshore Privately Offered Open-ended Fund Companies

PURPOSE

This paper briefs Members on the legislative proposal to extend profits tax exemption to privately offered open-ended fund companies ("OFCs") with their central management and control ("CMC") located in Hong Kong.

BACKGROUND

2. Asset management is a fast-growing sector within the financial services industry.[1] While Hong Kong has established itself as a premier international asset management centre, our asset management industry is mostly related to fund distribution and marketing activities. To keep our competitive edge and enable the industry to continue to develop and grow, we need to strengthen Hong Kong's role in the manufacturing and management of funds. More importantly, we need to encourage the domiciliation of funds in Hong Kong. This is because fund creation activities will drive demand for professional services such as fund management and investment advice, as well as legal, accounting, fund administration and other ancillary services, in addition to sales and marketing.

3. The introduction of the OFC regime is a key initiative to help diversify Hong Kong's fund domiciliation platform and build up our fund manufacturing capabilities. In June 2016, the Legislative Council ("LegCo") enacted the Securities and Futures (Amendment) Ordinance

[1] At the end of 2015 (year with latest available figure), the combined fund management business in Hong Kong amounted to around $17,393 billion.

2016 to provide a legal framework for the OFC structure[2] in Hong Kong. With the introduction of this new form of investment fund vehicle, we hope to attract more publicly and privately offered funds to domicile and promote fund origination in Hong Kong, thereby diversifying the development of our asset management industry.

4. However, having just the legal regime for a new fund vehicle is not sufficient. Parity of tax treatment is another consideration influencing the choice of jurisdiction for fund domiciliation and management. As an on-going effort to promote fund creation and management in Hong Kong, publicly offered funds (whether their CMC is located in or outside Hong Kong) authorised by the Securities and Futures Commission ("SFC") and offshore (whether publicly or privately offered) funds are already exempted from profits tax under our current taxation regime. Yet, onshore privately offered funds are still subject to profits tax. In other words, when the OFC regime comes into operation, publicly offered OFCs (whether their CMC is located in or outside Hong Kong) and offshore OFCs (whether publicly or privately offered) will be exempted from profits tax, while onshore privately offered OFCs cannot enjoy the same exemption. Given such disparity in tax treatment, most privately offered funds would prefer staying offshore rather than domiciling in Hong Kong using the new OFC regime. In order to remove this disincentive for fund domiciliation and management in Hong Kong, the Financial Secretary has proposed in the 2017-18 Budget that the Inland Revenue Ordinance ("IRO") (Cap. 112) be amended to extend profits tax exemption to **onshore privately offered OFCs (hereinafter referred to as "subject OFCs")**.

THE PROPOSAL

5. We propose that a privately offered OFC should satisfy the four conditions as set out in paragraphs 6 to 10 below in order to be able to enjoy profits tax exemption. The conditions seek to provide relevant safeguards to prevent abuse. We are also mindful of the need for tax incentive schemes to meet the latest international standards under the

[2] An OFC is an open-ended collective investment scheme set up in the form of a company, but with the flexibility to create and cancel shares for investors' subscription and redemption in the funds, which is currently not enjoyed by conventional companies. Also, OFCs will not be bound by restrictions on distribution out of share capital applicable to conventional companies, and instead may distribute out of share capital subject to solvency and disclosure requirements.

Base Erosion and Profit Shifting package of the Organisation for Economic Co-operation and Development, so as to avoid double non-taxation or the shifting of profits to low-tax regimes, etc. In January - April 2016, we consulted the industry on the concept to grant profits tax exemption to the subject OFCs. The industry generally welcomes the idea. The proposal below has incorporated industry feedback received then.

Condition 1: The OFC must be a Hong Kong resident person.

6. A privately offered OFC must be a resident person with its CMC located in Hong Kong in order for it to be eligible for profits tax exemption. In other words, it must be an onshore fund.

Condition 2: The OFC must not be closely held.

7. A subject OFC eligible for profits tax exemption cannot be closely held. This aims to ensure that the OFC is not owned by only a few individuals or corporate investors. Otherwise, an individual or 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. It is also our policy intent to grant tax exemption to certain wholesale funds. Although wholesale funds normally have only one institutional investor[3] and a few other investors, it is not uncommon for such funds to have a larger number of underlying investors or beneficiaries. To this end, the proposed **"not closely held" condition (hereinafter referred to as "NCH condition")** is set out at the **Annex**.

Condition 3: The OFC must carry out transactions in asset classes permissible for privately offered OFCs as specified in the OFC Code.

8. The SFC will specify in the OFC Code[4] the asset classes that privately offered OFCs may invest in. The investment scope of privately

---

[3] Examples of institutional investors include funds established for non-profit-making purposes, pension funds, funds invested in by a publicly offered fund (i.e. fund of funds) and funds with a governmental entity as the major institutional investor.

[4] The Securities and Futures (Amendment) Ordinance 2016 provides a legal framework for the OFC structure, while the operational and procedural details will be set out in subsidiary legislation and the OFC Code which are being prepared by the SFC and relevant departments at the moment. We will separately consult the LegCo Panel on Financial Affairs on those once ready.

offered OFCs should largely align with Type 9 (asset management) regulated activity, i.e. securities and futures ("permissible asset classes"), with a degree of flexibility by allowing a 10% *de minimis* limit (i.e. a maximum of 10% of the total gross asset value of the fund) for investing in "non-permissible asset classes".

9. We propose that an eligible subject OFC be exempted from payment of profits tax in respect of profits derived from transactions in the "permissible asset classes" specified in the OFC Code carried out through or arranged by a specified person (see Condition 4 below).

Condition 4: Transactions of the OFC must be carried out through or arranged by a specified person.

10. We propose that the activities that generate profits from the transactions must be carried out through or arranged by corporations or authorised financial institutions licensed or registered under the Securities and Futures Ordinance (Cap. 571) (i.e. specified persons). This is to ensure that the subject OFCs enjoying tax exemption would have substantial activity in Hong Kong and contribute to Hong Kong's economy by hiring local investment managers.

Measures to prevent abuse

11. To prevent possible abuse, we propose to include in the legislative framework the following measures –

(a) a subject OFC will be required to continue to meet the NCH condition for a further period of 24 months after the first 24-month period (section A at the **Annex**). Otherwise, we will "dis-apply" the tax exemption and the OFC will then be chargeable to tax for the 24-month start-up period. This aims to prevent individuals or entities from taking advantage of the tax exemption in the first 24-month period (e.g. by repeatedly opening and closing a subject OFC every 24 months);

(b) profits of a subject OFC derived from transactions of the "non-permissible asset classes" (if any) (paragraphs 8 and 9 above) will be subject to tax. This is to prevent a fund from converting taxable income (e.g. gains from sales of Hong Kong immovable properties) to non-taxable income via an OFC structure. If the 10% *de minimis* threshold is not

exceeded, only profits derived from transactions in "non-permissible asset classes" will be chargeable to profits tax. If the 10% *de minimis* threshold is exceeded, the tax exemption of the subject OFC will be lost (i.e. all profits will be wholly chargeable to profits tax);

(c) a resident person who, alone or jointly with his associates, holds direct and/or indirect beneficial interest of 30% or more in a tax-exempt OFC or sub-fund, will be deemed to have derived assessable profits in respect of the trading profits earned by the OFC. The same provisions are already applicable to offshore funds. This aims to prevent abuse or round-tripping by resident persons disguised as an eligible subject OFC to take advantage of the exemption; and

(d) consideration or remuneration received by investment managers for providing investment services to tax-exempt OFCs in the course of a trade or business carried on in Hong Kong should be chargeable to profits tax. Currently, section 26(a) of the IRO provides for profits tax exemption of dividends received from corporations which are chargeable to profits tax.[5] As a subject OFC (which is a "corporation") is chargeable to tax in respect of profits derived from transactions in "non-permissible asset classes", section 26(a) of the IRO will apply. This may create a loophole by which 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 (and hence should be chargeable to tax). We therefore propose to include an express provision to plug this possible loophole.

ADVICE SOUGHT AND WAY FORWARD

12. Members are invited to note and comment on the proposal as set out in paragraphs 5 to 11 above. Meanwhile, we will consult the industry again before finalising the legislative amendments. Our target is to introduce an amendment Bill into LegCo in the second half of 2017 for

[5] The policy intent of the existing section 26(a) is to ensure taxation at one but not two levels (i.e. the corporation is taxed and the shareholder is not taxed).

the proposed profits tax exemption to be implemented in tandem with the commencement of the OFC regime, currently expected to be in 2018.

Financial Services and the Treasury Bureau
8 March 2017

Annex

Proposed requirements for the "not closely held" condition

An **onshore privately offered open-ended fund company (hereinafter referred to as "subject OFC")** will be regarded as "not closely held" subject to fulfilling **the following requirements (hereinafter referred to as "NCH condition")** –

A. Ownership requirement

(a) at all times upon expiry of the first 24 months after a subject OFC accepts its first investor, **where the OFC has one or more than one qualifying investor** –

(i) the number of investors[1] in the OFC who are not the originator and the originator's associates exceeds four;

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

(iii) the participation interest of an investor, other than the qualifying investor, in the OFC exceeds $20 million but does not exceed 50%; and

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

(b) at all times upon expiry of the first 24 months after a subject OFC accepts its first investor, **where the OFC has no qualifying investor** –

[1] An investor in a subject OFC can be a natural person or a person as defined in section 2 of the Inland Revenue Ordinance (which includes "a corporation, partnership, trustee, whether incorporated or unincorporated, or body of persons"). Should there be suspicion of any abuse of the NCH condition to avoid the liability of tax, the Inland Revenue Department will rely on the existing anti-avoidance provisions under sections 61 and 61A of the Ordinance to take appropriate follow-up action. These include arrangements to counteract the tax benefit which would otherwise be obtained.

(i) the number of investors in the OFC who are not the originator and the originator's associates exceeds nine;

(ii) the participation interest of an investor in the OFC exceeds $20 million but does not exceed 50%; and

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

A "qualifying investor" means certain specified types of institutional investors, including 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 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 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 "qualifying 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 qualifying investor in a subject OFC, we reckon that it would prefer holding at least 50% participation interest. According to industry data, a qualifying 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-qualifying investor to hold a particularly large stake of the OFC. Hence, the participation rate of any non-qualifying investor should not exceed 50% and that of the originator and its associates should not exceed 30%. Meanwhile, the participation interest of a non-qualifying 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 upon 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 not 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, we propose to allow a subject OFC to have 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 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 not 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.

Safe harbour rules

4. To cater for the actual operation circumstances that an OFC may encounter, we propose to provide safe harbour rules under which a subject OFC may claim, by application to the Commissioner of Inland

Revenue ("CIR"), tax exemption even if it fails to meet any of the three requirements under the NCH condition under at least one of the following two special circumstances –

(a) the subject OFC's activities and investments are being wound down and it has sent notices to its members notifying them of the decision to wind down its activities and investments; or

(b) the subject OFC can continue to be treated as being "not closely held" having regard to temporary and out-of-control circumstances (e.g. a significant number of investors redeeming their shares and exiting the fund in a short period of time owing to market fluctuations).

5. In addition, considering that compliance with the 10% *de minimis* limit may depend on fluctuations in market value that are out of the OFC's control, we propose to provide a safe harbour rule under which a subject OFC may claim tax exemption by application to the CIR, provided that it can satisfy the CIR that the 10% threshold is exceeded due to circumstances which significantly reduce the value or amount of the OFC's assets and which are not reasonably foreseeable by the OFC.

- End -