Hong Kong Investment Funds Association

Bills Committee on Inland Revenue (Amendment) (No. 6) Bill 2017
Hong Kong Investment Funds Association
Views/comments gathered from members

It is imperative that the Inland Revenue Department ("IRD") provides clarifications on the following:

1. Whether funds and fund manager are regarded as "associated persons" on the basis that "participation condition" is met

To clarify that a fund and its fund manager should not be deemed to have met the "participation condition" under Section 50AAH(2)(b) and hence become "associated persons" notwithstanding the fund's investment or business affairs are managed in accordance with the directions or instructions of the fund manager or the fund manager may hold the "management shares" in the fund. Funds are typically invested by third party investors without connection nor relationship with the fund manager; and fund management fee charged by the fund manager to the funds are transparent to the underlying investors and ultimately borne by the underlying investors of the fund. Therefore, the underlying investors agree to the fees when they decide to invest into the fund, and despite the discretionary investment arrangement between the fund and the fund manager, they should not be regarded as "associated persons". Otherwise, this would lead to unreasonable outcome and would create additional tax compliance and/or reporting costs and burden to the funds from transfer pricing perspective.

Please note that even if a fund has a limited number of investors, the risk of a Hong Kong tax advantage arising from the management fee paid by the fund to the investment manager is low. For example, consider a fund with five investors, and two of the investors are connected with the investment manager (e.g. they are directors of the IM). Consider also that collectively, the two investors represent 80% of the total AUM of the fund. The remaining three investors, in all aspects third party investors, comprise the remaining 20%.

Then even if the fund's management fee payment to the investment manager would fall into scope of a transfer pricing review, the transaction has a natural, internal benchmark showing the amount is arm's length. That management fee paid by the fund is not only paid by the two main investors, it has also been agreed to by the three external investors. Therefore, the fund management fee the fund pays is likely to be very low risk. And the main transfer pricing arrangement to be analysed is how that management fee revenue is shared between the IM and any other entities on the investment management side of the group, e.g., a Hong Kong onshore Investment Advisor.

2. Interpretation of "arm's length amount"

It is important to clarify that an "arm's length amount" should not be a fixed/specific amount and depending on the situation, a range of amounts may still be regarded as "arm's length" (similar to how a market works – varying price range may exist). Specifically, in determining whether an amount is at "arm's length" for the purpose of Section 50AAF, whether an amount that falls within the arm's length range established in a way consistent with what is prescribed by 2017 OECD Transfer Pricing Guidelines should suffice. Given the interpretation of "arm's length amount" has impacts on Section 50AAF(5) – IRD empowered to make additional assessment based on an estimated arm's length amount and associated penalty sections (e.g. Section 82A(1C)) respectively, we would exhort IRD to provide guidance in this regard.

Separately, can IRD provide more guidance and clarity regarding how the assessor would make an estimation of the arm's length amount under Section 50AAF(5) in practice?

Please clarify that in practical terms, the use of benchmark data to estimate an arm's length range of prices or profits is expected to demonstrate satisfaction of the arm's length principle and the "arm's length amount".

Please also confirm that if the taxpayer's actual price or profit outcome is within the arm's length range of benchmark data accepted by the IRD, then the inspector would not make any adjustment to the taxpayer's income or loss.

3. Interaction between Schedule 17G, Section 50AAK and Section 14 of the Inland Revenue Ordinance ("IRO")

Fund managers are typically acting non-exclusively for a number of funds in its ordinary course of fund management business and therefore would likely meet the definition of an "independent agent" for the purpose of Schedule 17G, irrespective of Part 2 (Double Tax Agreement ("DTA") or Part 3 (non-DTA), both of which are modelled and drafted according to OECD principles and guidelines. With reference to tax treaties that Hong Kong has signed, a DTA territory resident person (i.e. an offshore fund) shall not be deemed to have a permanent establishment ("PE") in Hong Kong if the Hong Kong fund manager is acting as an independent agent on behalf of the offshore fund. No further consideration is required to be given to domestic legislation - Section 14 of the IRO. However, pursuant to the current Section 50AAK Part 3 (non-DTA), it appears that consideration under Section 14 on "carrying on business" is still required even if the "independent agent" condition is met and thus no PE is created by the fund manager on behalf of the fund. This creates disparity on the tax treatment for an offshore fund located in DTA and non-DTA jurisdictions with Hong Kong fund manager.

To promote the Hong Kong asset management industry and to create a level playing field for DTA and non-DTA circumstances, we would exhort IRD to align the profits tax position of offshore funds by only making reference to Schedule 17G – definition of PE in Hong Kong for assessing whether the offshore fund may be subject to Hong Kong profits tax or not?

Furthermore, even if a non-DTA territory resident person (an offshore fund) is deemed to have a PE in Hong Kong by definition under Section 50AAK, can IRD confirm that any income/loss attributed to the PE should be assessed according to source rules under Section 14 such that only profit or loss which arises in or derived from Hong Kong would be chargeable to profits tax?

Ultimately, does the fund exemptions (under Sections 20AC, 20ACA, and 26A) override Section 50AAK as they currently override Section 14?

Can IRD consider offering something similar to the UK's onshore investment manager's exemption, whereby HMRC agrees not to tax a fund via PE argument provided certain conditions are met, such as: the funds are widely held, the onshore entity is paid an arm's length fee?

(End)