pwc

羅兵咸永道

Hon Kenneth Leung
Chairman
Bills Committee on Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Central
Hong Kong

Sent by email to: bc_06_18@legco.gov.hk

11 January 2019

Submission on Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018

Dear Hon Kenneth Leung,

We refer to the public invitation for submission on the Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018 (the Bill), which seeks to provide a profits tax exemption to eligible funds operating in Hong Kong.

We welcome the Hong Kong SAR Government's efforts to develop Hong Kong's asset and wealth management industry and believe that these changes will put Hong Kong in a much more competitive position as a regional and international asset and fund management centre. The Bill allows the flexibility for a fund to have Hong Kong company directors and hold board meetings in Hong Kong, while still enjoying a profits tax exemption. We expect that this change would attract talent to Hong Kong and help retaining talent, echoing the message in the Chief Executive's 2018 Policy Address.

The Bill brings fundamental changes to how the profits tax exemption for privately offered funds is applied in practice, in particular the removal of ring-fencing and tainting features. We are pleased to see that the various current profits tax exemptions to privately offered funds are now unified into one comprehensive regime.

We set out our key comments on the Bill below and other supplementary matters in the Appendix for the consideration of the Bills Committee.

1. Definition of "fund"

   We note that the proposed definition of fund in section 20AM is similar to the existing definition of "collective investment scheme" in the Securities and Futures Ordinance, with certain modifications. We appreciate the legislature's coverage of most fund arrangements and are pleased to see that a sovereign wealth fund is explicitly included in the definition. However, we note that some other common fund arrangements may not fall within the current proposed definition of fund. These include:

   a. Pension funds - it is not clear whether they would be considered a "fund" under section 20AM(2)(b) in the Bill in cases where the pension fund of a company is managed or operated by the employees and/or beneficiaries of the company who are also the "participating persons" of the fund. In addition, some pension funds of overseas countries that set up a wholly owned

subsidiary to be its own fund manager may not qualify as a fund by virtue of section 20AM(5)(c).

b. Employee investment fund vehicles, including genuine fund vehicles where the management team consists of employees of the fund vehicle or a subsidiary of the fund vehicle appear to not qualify as a fund by virtue of section 20AM(5)(c).

Clarification on the above, and elaboration on the reasoning behind excluding these types of arrangements (where applicable), will be appreciated. If the concern is over tax avoidance or abuse of the profits tax exemption by Hong Kong tax residents, we are of the view that the deeming provisions, as proposed in Section 20AX, would be sufficient to deal with such potential abuse.

2. Tax exemption for open-ended fund companies

We would like to seek clarification on section 20AN(2)(c) in the Bill and its interaction with section 20AS.

We understand the current situation is that an open-ended fund company (OFC) is allowed to invest in "permissible assets", and these assets are those that require a Type 9 Securities and Futures Commission (SFC) licence to manage. At the same time, an OFC is also allowed, under the OFC Code issued by the SFC, to invest in not more than 10% of its gross asset value in "non-permissible assets". Exceeding the 10% threshold would make the fund not an OFC for regulatory purposes, and therefore the OFC profits tax exemption would not apply.

Section 20AN(2)(c) in the Bill provides tax exemption to an OFC in respect of its assessment profits derived from "transactions" in non-permissible assets (i.e. assets of a class that is not specified in the proposed Schedule 16C). On the other hand, section 20AS of the Bill stipulates that, despite section 20AN, an OFC is not exempt from payment of tax in respect of its assessable profits derived from "direct trading" in non-permissible assets, "direct business undertaking" in non-permissible assets and the "utilisation" of non-permissible assets to generate income.

In this regard, the above two provisions appear at first glance to be somewhat contradictory. Nonetheless, having studied the matter, we assume that the legislative intent is to interpret (1) "transactions in non-permissible assets" as the "purchase and disposal" of such assets in conjunction with a normal investment business rather than as part of an active trading business and (2) "direct trading in non-permissible assets" as meaning transactions conducted as part of an active trading business (rather than mere investment) and therefore excluding "transactions in non-permissible assets" as discussed above. If the above is correct, we recommend that the above should be clearly specified in the Bill or that references to "direct trading" in the context of section 20AS should be removed; doing so would add clarity and certainty but the profits from active trading would remain taxable as they are likely to be considered to arise from a "direct business undertaking in Hong Kong".

For the avoidance of any doubt, we would also like to confirm that even if an OFC is not exempt from payment of tax under section 20AS (say because it has engaged in the direct business undertaking in non-permissible assets), it would continue to be exempt from tax for its assessable profits derived from transactions in permissible assets and incidental transactions, and will only subject to tax on its assessable profits derived from the direct business undertaking in non-permissible assets.

pwc

3. Tax exemption for special purpose entities participating in the ITVF Scheme

We refer to section 20AO(2) in the Bill which specifies the profits tax exempt transactions in respect of a special purpose entity (SPE). The section exempts a SPE from payment of profits tax in respect of assessable profits derived from transactions in specified securities of a **private company** or an interposed SPE, without requiring that the transactions be in the permissible assets as specified in the proposed Schedule 16C (one of which being "an investee company's shares co-invested by a partner fund and Innovation and Technology Venture Fund Corporation (ITVFC) under the ITVF Scheme").

Based on the above, we would like to confirm that if a fund indirectly holds a private company through a SPE/an interposed SPE and the private company is co-invested by the ITVFC under the ITVF Scheme, the SPE is eligible for the profits tax exemption under section 20AO(2) in respect of its assessable profits derived from the transactions in that private company.

4. Other definitions

We recommend that the proposed definitions of "investee private company" and "private company" in section 20AO(4) be amended as follows:

- *investee private company* – we suggest changing the definition to: "in relation to a fund, means a private company held by a special purpose entity or an interposed special purpose entity ~~as a shareholder on behalf of the fund~~ **directly or indirectly held by the fund in part of in whole**" . This is to ensure that the SPE or the interposed SPE would not be regarded or interpreted as a "look through" / transparent or nominee entity.

- *private company* – we suggest changing the definition to: "means a company (whether incorporated in or outside Hong Kong) that is not allowed to issue **or has not issued at any time,** any invitations to the public to subscribe for any shares or debentures of the company".

Please also clarify whether a fund can invest in a private non-corporate entity (e.g. a partnership or a trust) which is common legal vehicle for private enterprises in overseas jurisdictions like Luxembourg and Japan.

5. Tax exemption for funds investing in a private company that became listed before disposal

We refer to sections 20AP and 20AQ in the Bill and their application to the following situation:

> A fund invested in a private (unlisted) company that holds less than 10% of its assets in immovable property in Hong Kong (in the case of section 20AP) or that does not hold any immovable property in Hong Kong (in the case of section 20AQ), and the fund has held the private company for less than 2 years. Before disposing the investment (within the 2-year holding period), the private company's shares became listed (i.e. falling within the definition of "securities" under the proposed Schedule 16C at the time of disposal).

We would like to seek a confirmation that sections 20AP and 20AQ would not apply and the fund can enjoy the profits tax exemption, provided all other conditions are met.

6. The short-term assets test

   Under the proposed short-term assets test in sections 20AP and 20AQ, the tax exemption will not apply if a fund holds a private company for less than 2 years, has a controlling stake in such private company and the private company holds more than 50% of its asset value in "short-term assets" as defined. This means investments by a fund in the retail industry (e.g. supermarkets and car dealerships) would not be tax-exempt unless the "2-year holding period test" is met or the fund does not have a controlling stake in the investments. This seems to be an unintended consequence of the short-term assets test. In order not to discourage investments in the retail industry by funds, we recommend that short-term assets as defined in section 20AP(4) be restricted to short-term assets in Hong Kong only, and not short-term assets outside of Hong Kong.

7. Permissible assets specified in Schedule 16C

   The classes of assets specified in the proposed Schedule 16C do not include ownership interests in a partnership or a trust. We would like to seek a clarification on whether it is the legislative intent to exclude transactions in a private partnership or a trust as tax-exempt transaction and the reasoning of such exclusion.

8. Utilisation of losses sustained by OFCs

   We refer to section 20AV(3) in the Bill which specifies that any loss sustained by an OFC from **a** specified activity in respect of which there is not a tax exemption for a year of assessment can only be used to set off against any assessable profits of the OFC earned from **the** specified activity for that year of assessment or any subsequent year of assessment. "Specified activity" is defined to mean a transaction, a direct trading, a direct business undertaking or utilisation of assets.

   It appears to us that the above means a loss sustained by an OFC from specified activity X cannot used to set off against its assessable profits earned from specified activity Y, even though both activities X and Y were non-tax exempt activities carried out by the same taxpayer under the same trade or business. This seems to deviate from the current and long established rule that tax losses sustained by a taxpayer in a year of assessment from a trade or business carried on by it can be used to set off against the assessable profits of the same taxpayer in that year of assessment or any subsequent year of assessment.

   In this regard, we would like to seek a clarification on whether section 20AV(3) is intended to introduce a new tax loss offset rule for OFCs and if yes, the justification of such new rule for OFCs.

9. Effective date of the new tax exemption regime for funds

We note that the provisions in the Bill, once enacted into law, will come into operation on 1 April 2019. We also note that the proposed section 20AC(1A) mentions that a fund (as defined under the new tax exemption regime) will only be excluded from being a "non-resident person" under the old tax exemption regime on and after 1 April 2019. Based on the above, for funds that are with an accounting year end date of say, June 30 or December 31, the new tax exemption regime will only apply to part of their basis periods for year of assessment 2019/20. In this regard, we would like to request the HKSAR Government to consider allowing funds to apply the new tax exemption regime for their whole basis periods for year of assessment 2019/20.

We thank you again for the opportunity to provide our comments on the Bill and would be pleased to provide further details on the above if necessary. If you have any questions on our submission, please do not hesitate to contact Charles Lee (at 2289 8899 or charles.lee@cn.pwc.com) or Florence Yip (at 2289 1833 or florence.kf.yip@hk.pwc.com).

Yours sincerely,
For and on behalf of PricewaterhouseCoopers Limited

Charles Lee
PwC China South and Hong Kong Tax Leader

Florence Yip
Asia Pacific Tax Leader, Financial Services and Asset & Wealth Management

pwc

Appendix – Other comments for consideration

1. On the tax treatment of incidental transactions, we note that this has remained the same (both in the existing tax law and proposed law applicable to funds in the Bill). Given this opportunity to revamp the existing tax regime for funds, we would like to restate our suggestion made in our prior submissions, that is, the Hong Kong SAR Government should consider making policy changes to support and encourage the development of the debt instrument market in Hong Kong, which would echo the message given by Financial Secretary Mr Paul Chan in his 2018-19 Budget Speech. Changes are needed in the tax law to bring offshore bond funds onto an equal footing with their equity hedge fund or private equity fund counterparts, by making it clear that interest derived on bonds held by a bond fund is not to be considered as income from incidental transactions for the purpose of the tax exemption[1].

2. On the deeming provisions to prevent tax leakage and round tripping, we note that they have resulted in some unintended consequences. Specifically, they have discouraged Hong Kong headquartered groups from engaging Hong Kong investment managers to manage and invest the excess cash arising from the offshore operations of their overseas entities as doing so would potentially expose the investment income to Hong Kong profits tax under the deeming provisions (e.g. a Hong Kong headquartered insurance group with operations in Japan will be caught by the deeming provisions if it were to engage a Hong Kong investment manager to manage the insurance funds of its Japanese subsidiary). There is clearly no intention to avoid tax in such instances. In fact, this will likely lead to double taxation of the same investment income (i.e. taxation in the overseas jurisdictions where their overseas entities operate and also taxation in Hong Kong under the deeming provision). The Hong Kong SAR Government should consider making policy changes to remove such unintended consequences (e.g. by introducing an escape clause in the deeming provision to give the IRD a discretion not to apply such provision if the Hong Kong headquartered groups can demonstrate that they do not have the motive of avoiding tax) and encourage the growth and development of the asset management industry in Hong Kong.

---

1 Under the current offshore funds tax exemption, there is an inherent disadvantage to investment managers wanting to manage unauthorised offshore bond funds in Hong Kong, owing to the fact that a significant portion of the total income derived by a bond fund is 'interest income'. The IRD's stance on 'interest income' from Hong Kong issued bonds under the current profits tax exemption for offshore funds is that interest income is 'income from incidental transactions' as opposed to 'income from specified transactions'; this means that the interest income does not enjoy the same exemption offered to most other investments held by offshore funds (unless the interest income is less than 5% of the total trading receipts of the offshore fund – which is difficult to achieve by a bond fund adopting a buy and hold strategy).