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(English version only)

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Clerk to Bills Committee on
Inland Revenue (Profits Tax Exemption for Funds)
(Amendment) Bill 2018
Legislative Council Secretariat
Legislative Council Complex
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Central, Hong Kong

Our ref DB/MJP/Bills Committee letter
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11 January 2019

Dear Sir or Madam:

Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018 ("the Bill")

Thank you for the opportunity to submit KPMG's views on the abovementioned legislation. KPMG welcomes the proposed introduction of a new comprehensive exemption from Hong Kong profits tax for private funds ("New Exemption") and note that these views have been echoed in discussions we have had with a number of participants in the fund industry since the introduction of the Bill. We congratulate the Government on this positive move and are sure that it will help to promote the funds industry in Hong Kong.

We are pleased that a number of issues with the existing Offshore Funds Exemption and tax exemption for Open Ended Fund Companies ("OFCs") have been addressed in the Bill. This includes:

— Removing tainting provisions which previously resulted in a fund being unable to rely on the exemption at all if they had one non-qualifying investment

— Providing a level playing field for both onshore and offshore funds, with the one exemption applying to both

— Extending the coverage of the new exemption to Sovereign Wealth Funds which are a key source of capital and an active investor in all major fund markets

— Encouraging future investment in Hong Kong infrastructure projects through the inclusion of infrastructure assets as qualifying investments

— Removal of onerous qualifying conditions for OFCs to be exempt from Hong Kong profits tax

— Removal of deeming provisions in previous OFC tax exemption legislation relating to management fees and certain dividends which would have resulted in Hong Kong being out of step with other major fund centres and taxing carried interest generated by a fund

In our experience, many of these issues have either prevented funds with existing operations in Hong Kong being willing to place reliance on the existing profits tax exemptions for funds or have resulted in new funds being reluctant to establish operations in Hong Kong to manage the investments of those funds. This has partially been due to the level of certainty that these organisations need on how legislation would be interpreted by tax authorities in order to be able to fulfil undertakings that they must make to investors when raising funds about not exposing the income of the fund vehicle to tax in the jurisdictions in which their investment teams are based.

In reviewing the draft legislation, we have identified some remaining areas which could still result in foreign fund organisations being reluctant to establish / expand operations in Hong Kong. We emphasise that it would be important to address as many of these areas of uncertainty through amendments to the final legislation rather than through guidance. This is the approach commonly adopted in other leading fund jurisdictions as foreign funds typically place primary reliance on the content of legislation, and less emphasis on guidance issued by tax authorities. Specific examples of remaining areas of uncertainty include:

— The definition of Special Purpose Entity ("SPE") in new section 20AO of the Inland Revenue Ordinance stipulates that to be a SPE and rely on the tax exemption provided by that section, the SPE must be established solely for the purpose of holding and administering one or more "investee private companies". We note that the investment portfolios of private equity funds and many other fund types tends to be quite broad and will include investments in listed companies. This could be either an interest in a portfolio company retained following an IPO or a strategic investment in a listed company. These investments will often be held by a special purpose holding company for legal asset protection reasons. Based on the current drafting of Section 20AO, any gain from the disposal of such investments would not be exempt from Hong Kong profits tax as the company would not satisfy the definition of an SPE. We strongly encourage that Section 20AO be amended to enable these types of investments to be covered by the New Exemption.

— Many common private equity structures will involve investments by SPEs in non-corporate entities (eg, partnerships, trusts, etc). Two common examples include investments in an Australian Managed Investment Trust (MIT) or in a Japanese Tokumei Kumiai (TK). Neither a MIT or a TK is a private company and as such would not satisfy the definition of an 'investee private company" in new Section 20AO. As a result, the SPE would not be able to rely on the New Exemption when exiting from those types of investments. We do not envisage that this is the intended impact and would recommend that the legislation be amended to allow a wider range of investments by SPEs to be covered.

— Section 20AQ provides a welcome change which means that if a Fund or a SPE of a fund holds an investment in a portfolio company for at least two years, then the gain on disposal will be exempt from Hong Kong profits tax. However, if disposed of within two years then the gain could become taxable if the Fund / SPE has control of the portfolio company. This applies where the "relevant company holds (directly or indirectly) short-term assets the aggregate value of which [exceeds] 50% of the value of the relevant company's assets".

  It is not entirely clear to us the situations that this clause is intended to cover, but as drafted, could have quite wide reaching impact. It would appear that it could prevent many types of investments by funds in retail businesses (eg., fashion retailers, supermarkets, car dealerships, etc) being able to rely on the New Exemption regardless of whether those retail businesses have any presence in Hong Kong. This cannot be the intended consequence and we would therefore encourage amendments to be made to limit the application of these provisions to short term assets in Hong Kong.

In addition, there are some areas of uncertainty that could be addressed through an updated version of Departmental Interpretation and Practice Notes ("DIPN") 51. These include:

- Providing further clarity on the types of entities covered by the definition of a 'Fund'. Examples include:
  - Whether Pension Funds can rely on the exemption. As you will be aware many Pension Funds from Europe, North America, Australia, etc are key participants in the funds industry and it would be important that they are covered by the exemption as not all will satisfy the requirements of Section 26A. In addition, Pension Funds will often use SPEs to hold investments. Those SPEs are not currently protected by Section 26A even if the Pension Fund does satisfy the requirements of that section. To provide a level playing field, it would be important that SPEs established by Pension Funds satisfying the requirements of Section 26A are able to access the new tax exemption for SPEs under new section 20AO.
  - Can a single investor fund qualify as a 'Fund'. The use of such entities is not uncommon in the wealth management industry and it would be helpful if such entities could access the New Exemption.
  - How the limitation in subclause 6 of the definition of the 'Fund' is intended to be applied. The limitation that "a business undertaking for general commercial or industrial purposes" is quite broad and could inadvertently apply to many funds that should be covered by the New Exemption. Clarification of the types of scenarios where this limitation is intended to be applied would be helpful.
- Details of the types of activities that can be performed by a SPE when 'holding and administering' an investee private company. The current comments in DIPN 51 on the types of activities that can be performed by the equivalent of a SPE under the Offshore Funds Exemption are quite restrictive and would often be exceeded in the normal governance of a portfolio investment by a SPE board. In addition, the restrictive nature of the permitted activities would make it very difficult for a SPE to obtain a tax residency certificate.

We believe that the proposed legislative changes can provide a significant boost to the funds industry in Hong Kong and help to put it on a level playing field with other leading fund centres in terms of the quality of tax exemptions provided to funds. We congratulate the Government for making this possible. However, we would strongly encourage that the remaining areas for improvement are appropriately addressed to ensure that there is not a repeat of the scenario in 2015 when Offshore Funds Exemption was extended to cover private equity funds. Our private equity fund clients have mostly been reluctant to rely on the extended tax exemption as the concerns of the industry where not adequately addressed through either amendments to the draft legislation or clear guidance on the relevant issues.

Yours faithfully
For and on behalf of KPMG Tax Services Limited

Darren Bowdern
Partner