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For discussion
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Legislative Council Panel on Financial Affairs

Proposed Profits Tax Exemption for Funds

PURPOSE

This paper briefs Members on the legislative proposal to provide profits tax exemption for funds operating in Hong Kong, regardless of the structure under which they are established[1] or their location of central management and control ("CMC")[2].

BACKGROUND

2. Asset and wealth management is a fast-growing sector within the financial services industry. As at 31 December 2017, the total assets under management by asset and wealth management business in Hong Kong amounted to $24,270 billion[3].

3. Under the Inland Revenue Ordinance ("IRO", Cap. 112), public funds, both onshore and offshore, are exempted from profits tax. Meanwhile, for privately offered funds, there is different tax treatment for onshore and offshore funds[4]. The Council of the European Union ("EU")

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[1] A fund can be in the structure of, for example, a unit trust, corporation or limited partnership.

[2] Funds with their CMC exercised in Hong Kong are regarded as "onshore funds". Those with their CMC exercised outside Hong Kong are regarded as "offshore funds". The CMC test is well established in common law for determining the residence of corporations, partnerships and trusts.

[3] The data is obtained from the Asset and Wealth Management Activities Survey 2017 conducted by the Securities and Futures Commission ("SFC"). In the survey, asset and wealth management business comprises asset management, fund advisory business, private banking and private wealth management business, and business of managing real estate investment trusts authorised by the SFC.

[4] These include offshore privately offered funds and offshore private equity funds (collectively known as "offshore funds" hereafter).

has identified our tax regimes for offshore funds to be problematic on account of the ring-fencing features[5].

4. Under the IRO, offshore funds may enjoy profits tax exemption on specified transactions as set out in Schedule 16 and incidental transactions. Such transactions should be carried out through or arranged by specified persons (i.e. licensed corporations or authorised financial institutions). If this "specified person" requirement is not met, the offshore fund must be a "qualifying fund" as defined in section 20AC(6) to qualify for profits tax exemption[6]. As only offshore funds, but not onshore funds[7], may enjoy profits tax exemption under the current regimes, the EU considers our tax regimes ring-fenced from the domestic economy at the fund level and thus harmful.

5. At the investment level, offshore funds with investments in private companies can enjoy tax exemption only if the investee private companies fall within the definition of "excepted private company" under section 20ACA(2). As "excepted private company" as currently defined only includes a private company incorporated outside Hong Kong, offshore funds cannot invest in local private companies if they wish to enjoy profits tax exemption. This is also seen by the EU as a ring-fencing feature.

6. To further consolidate Hong Kong's competitive edge in the manufacturing and management of funds and in order not to be put on the EU's list of non-cooperative jurisdictions for tax purposes, the Government announced in the 2018-19 Budget that a review would be conducted on the existing tax concession arrangements applicable to the fund industry with regard to the international requirements on tax co-

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[5] Ring-fencing occurs where the preferential tax treatment is partially or fully isolated from the domestic economy. It may take different forms, e.g. excluding resident taxpayers from taking advantage of the preferential tax treatment; and prohibiting qualifying resident taxpayers from operating in the domestic market. Qualifying resident taxpayers can be implicitly excluded from operating in the domestic market if the applicability of the preferential tax treatment is limited to transactions carried out with foreign parties.

[6] Basically, a "qualifying fund" should have at least five investors; the capital commitments made by the investors should exceed 90% of the aggregate capital commitments; and distribution of the net proceeds to the originator and its associates should not exceed 30%.

[7] Except onshore privately offered open-ended fund companies ("OFCs"). Please see paragraph 17 below.

operation. A task force led by the Financial Services and the Treasury Bureau and comprising members from the Inland Revenue Department, the Hong Kong Monetary Authority, and the SFC has been formed to conduct the review. Specifically, Hong Kong has committed to look into how to modify the tax regimes for offshore funds to address the EU's concerns about ring-fencing, and introduce the corresponding legislative amendments into the Legislative Council ("LegCo") by end-2018. Failure to do so may render Hong Kong to be listed as a non-cooperative jurisdiction for tax purposes by the EU, and expose Hong Kong to defensive measures (e.g. reinforced monitoring of certain transactions and withholding tax measures) which may be applied by EU Member States.

THE PROPOSAL

7. In addressing the EU's concern, we are guided by the principle of making changes that are necessary to remove ring-fencing tax features for fund entities while leaving intact other features under our existing tax regimes that are not related to fund entities per se. We have also taken the opportunity to adjust certain tax treatments for funds so that Hong Kong remains competitive in the face of increasing regional and international competition.

8. In April and May 2018, the Government conducted a four-week industry consultation on our preliminary proposal. Our proposal is essentially that onshore funds should enjoy the same tax incentive as offshore funds. This can address ring-fencing concern at the fund level. Also, a fund can enjoy profits tax exemption on its investment in both local and overseas private companies. This can address ring-fencing concern at the investment level. The industry understands the need to remove ring-fencing features but points out that the current IRO provisions on the tax treatment of offshore funds should be preserved as far as possible to avoid any inadvertent disruption to market operation. We have fine-tuned our proposal taking into account the industry's feedback. The proposal as elaborated in paragraphs 9 to 19 below will be set out in new provisions to be added to the IRO so that the new tax regime for funds will be self-contained, i.e. the existing provisions will be preserved except for the necessary changes.

Removal of ring-fencing at the fund level

9. In line with our objective to attract funds of different types and

sizes to Hong Kong, we propose that all funds, regardless of their structure, their CMC location, their size or the purpose that they serve, will enjoy profits tax exemption subject to meeting certain conditions. A definition of "fund", similar to the definition of "collective investment scheme" in Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571) ("SFO"), will be added to the IRO for this purpose[8]. The draft definition is at **Annex A**. To reduce the risk of tax abuses by onshore businesses repackaging themselves as funds, we propose to make it clear that a business undertaking for general commercial or industrial purpose is not a fund. For the sake of clarity, a fund's engagement in transactions in qualifying assets (or "qualifying transactions"; see paragraph 12 below for details) will not be regarded as a business undertaking for general commercial or industrial purpose.

10. In line with the existing tax exemption for offshore funds, we propose to require an entity meeting the definition of "fund" to engage a specified person to arrange or carry out its transactions or be a "qualifying fund" (see paragraph 4 above).

Removal of ring-fencing at the investment level

11. At present, offshore funds may enjoy tax exemption on profits from specified transactions and transactions incidental to the carrying out

[8] We will suitably modify the SFO definition of "collective investment scheme" so that the new definition of "fund" in the IRO can serve the purpose of profits tax exemption. Examples of the modifications include –

(a) arrangements made for the purposes of the Exchange Fund established by the Exchange Fund Ordinance (Cap. 66) should be included in the proposed definition of "fund" to provide tax certainty to them;

(b) arrangements which are arrangements, or are of a class or description of arrangements, prescribed by notice under section 393 of the SFO should be excluded from the proposed definition of "fund" as such arrangements may be prescribed as a "collective investment scheme" in the specific context and purpose of the SFO and may not be a typical "fund" for taxation purposes under the IRO;

(c) public funds which are currently exempted from profits tax under section 26A(1A) of the IRO should be excluded from the proposed definition of "fund". The public funds are subject to a separate profits tax exemption scheme which is outside the scope of the current exercise; and

(d) sovereign wealth funds should be expressly included in the proposed definition of "fund" for clarity sake.

of specified transactions. As for onshore privately offered OFCs[9], they may also enjoy tax exemption on profits from transactions in non-qualifying assets. To maintain status quo for the aforementioned funds, we propose that an entity that meets the definition of "fund" and fulfills the specified person requirement or has a qualifying fund status outlined in paragraph 10 above will be able to enjoy profits tax exemption on its profits generated from the following transactions –

(a) qualifying transactions (see paragraph 12 below);

(b) transactions incidental to the carrying out of qualifying transactions ("incidental transactions"), subject to a 5% limit as detailed in paragraph 18 below; and

(c) if the fund is an OFC, transactions in non-qualifying assets ("non-qualifying transactions")[10].

12. A list of the qualifying assets is at **Annex B**. In drawing up this list, we have considered the current tax regimes for offshore funds and OFCs to ensure that the tax exemption currently enjoyed by these funds will not be affected.

13. Private companies may hold any type of assets in Hong Kong. To reduce the risk of tax evasion[11] by funds through their investment in private companies, a fund will be taxed on its profits from investment in private companies that do not meet the following three tests –

(a) **immovable property test**: if a fund invests in a private company that holds, whether directly or indirectly, more than 10% of its assets in immovable property (excluding

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[9] They are subject to the SFC's regulation (including the 10% de minimis limit on their investment scope) on an ongoing basis.

[10] The profits that an OFC would receive from any direct trading or business undertaking in Hong Kong in non-qualifying assets or utilisation of non-qualifying assets with a view to generating income in Hong Kong will, however, be taxed.

[11] For example, trading assets chargeable to profits tax upon sale may become tax-exempted if the sale is structured through a fund which sells shares in a private company holding such trading assets.

infrastructure) in Hong Kong[12], the fund will be taxed on the profits arising from such an investment in the private company;

(b) **holding period test**: if the private company (i) does not hold, whether directly or indirectly, any immovable property in Hong Kong; or (ii) holds, whether directly or indirectly, not more than 10% of its assets in immovable property in Hong Kong, and the investment in the private company has been held by the fund for at least two years, the fund will not be taxed on the profits arising from the transaction of the private company. If the private company has been held by the fund for less than two years, the short-term assets test described in (c) below will apply;

(c) **short-term assets test**: if the holding period test at (b) above cannot be satisfied, profits tax exemption would only be provided if –

(i) the fund does not have a controlling stake in the private company; or

(ii) the fund has a controlling stake in the private company, but the latter does not hold more than 50% of the value of the company's assets in short-term assets. Short-term assets are assets (excluding qualifying assets and immovable property in Hong Kong) held by the private company for less than three years at the time of the transaction.

The diagram at **Annex C** shows how the above tests would operate in practice. The immovable property test and short-term assets test are not new. They have been incorporated in the tax exemption regime for onshore privately offered OFCs.

[12] The Government has considered whether this may be a ring-fencing feature. In general, the source jurisdiction has the right to tax gains from indirect transfer of immovable property located within its jurisdiction. The resident jurisdiction equally has the right to tax its own residents. Based on these principles, Hong Kong may not be able to tax capital gains derived from overseas immovable property (i.e. Hong Kong is neither the source jurisdiction nor the resident jurisdiction). Therefore, it would not be appropriate to carve out overseas immovable property as well.

14. For the avoidance of doubt, tax exemption will be provided at both the fund level, and if there is a special purpose entity ("SPE"), the SPE level to the extent which corresponds to the percentage of shares or interests held by the fund.

Anti-tax avoidance measures

15. To prevent tax leakage, we propose that anti-round tripping provisions currently applicable under the IRO will be applicable to funds, i.e. a resident person who, either alone or jointly with his associates, has a beneficial interest of 30% or more in a tax-exempt fund (or any percentage if the fund is the resident person's associate), will be deemed to have derived assessable profits in respect of the trading profits earned by the fund from the qualifying transactions. This aims to prevent abuse or round-tripping by a resident person disguising as a fund to take advantage of the exemption.

16. In sum, a fund which is not an OFC shall be assessed to tax on the profits from non-qualifying transactions, while an OFC shall be assessed to tax in respect of profits from direct trading or direct business undertaking in Hong Kong in non-qualifying assets or in respect of the utilisation of such non-qualifying assets with a view to generating income. All funds will be taxed on its profits from investment in private companies that cannot satisfy the tests under paragraph 13 above. We propose that there will be no tainting, i.e. the tax-exempt profits of the fund will not be tainted even if a fund is taxed.

Other matters

(a) OFCs

17. We have put in place profits tax exemption arrangements for onshore privately offered OFCs vide the Inland Revenue (Amendment) (No. 2) Ordinance 2018. To ensure that there is a level playing field and avoid market confusion, we consider it appropriate that the tax treatment for funds as set out in paragraphs 9 to 16 above should be applied to OFCs. We will make suitable amendments to the existing provisions to give effect to this.

(b) Tax treatment of incidental transactions

18. The current tax treatment for incidental transactions will be retained, i.e. profits derived from such transactions will be tax-exempt provided that the trading receipts from the incidental transactions do not exceed 5% of the total trading receipts from both qualifying transactions and incidental transactions. If the 5% threshold is exceeded, the whole of the receipts from the incidental transactions will be chargeable to profits tax.

(c) Remuneration to investment managers

19. The current principles on taxation of remuneration to investment managers will remain unchanged and we do not see a need to introduce any specific provisions in the Bill. The principles are that remuneration received by investment managers in respect of their professional services provided in Hong Kong will be subject to taxation.

ADVICE SOUGHT AND WAY FORWARD

20. Members are invited to note and comment on the proposal as set out in paragraphs 9 to 19 above. Our target is to introduce an amendment Bill into LegCo by end-2018 in order to honour Hong Kong's commitment to the EU.

Financial Services and the Treasury Bureau
26 October 2018

Annex A

Proposed definition of "fund"

fund (基金) means —

(I) an arrangement in respect of any property —

(a) under which the participating persons[1] do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions in respect of such management;

(b) under which—

(i) the property is managed as a whole by or on behalf of the person operating the arrangements;

(ii) the contributions of the participating persons and the profits or income from which payments are made to them are pooled; or

(iii) the property is managed as a whole by or on behalf of the person operating the arrangements, and the contributions of the participating persons and the profits or income from which payments are made to them are pooled; and

(c) the purpose or effect, or pretended purpose or effect, of which is to enable the participating persons, whether by acquiring any right, interest, title or benefit in the property or any part of the property or otherwise, to participate in or receive—

(i) profits, income or other returns represented to arise or to be likely to arise from the acquisition, holding, management or disposal of the property or any part of the property, or sums represented to be paid or to be likely to be paid out of any such profits, income or other returns; or

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[1] Pursuant to section 7(2) of the Interpretation and General Clauses Ordinance (Cap. 1), words and expressions in the singular include the plural and words and expressions in the plural include the singular. Hence, "participating persons" also means "a participating person".

(ii) a payment or other returns arising from the acquisition, holding or disposal of, the exercise of any right in, the redemption of, or the expiry of, any right, interest, title or benefit in the property or any part of the property; or

(II) an arrangement that is commonly known as a sovereign wealth fund established and funded by a state or government (or any political subdivision or local authority of a state or government) for the purposes of—

(a) carrying out financial activities; and

(b) holding and managing a pool of assets,

for the benefit of the state or government (or the political subdivision or local authority);

but does not include—

(i) arrangements operated by a person otherwise than by way of business;

(ii) arrangements under which each of the participating persons is a corporation in the same group of companies as the person operating the arrangements;

(iii) arrangements under which each of the participating persons is a bona fide employee or former employee of a corporation in the same group of companies as the person operating the arrangements, or a spouse, widow, widower, minor child (natural or adopted) or minor step-child of such employee or former employee;

(iv) franchise arrangements under which the franchisor or franchisee earns profits or income by exploiting a right conferred by the arrangements to use a trade name or design or other intellectual property or the goodwill attached to it;

(v) arrangements under which money is taken by a solicitor from his client, or as a stakeholder, acting in his professional capacity in the ordinary course of his practice;

(vi) arrangements made for the purposes of any fund or scheme maintained by the Securities and Futures Commission, or by a recognised exchange company, recognised clearing house, recognised exchange controller or recognised investor compensation company, under any provision of the Securities and Futures Ordinance (Cap. 571) for the purpose of providing compensation in the event of default by an exchange participant or a clearing participant;

(vii) arrangements made by any credit union registered under the Credit Unions Ordinance (Cap. 119) in accordance with the objects thereof;

(viii) arrangements made for the purposes of any chit-fund permitted to operate under the Chit-Fund Businesses (Prohibition) Ordinance (Cap. 262); and

(ix) mutual funds, unit trusts or other similar investment schemes that are authorised as collective investment schemes under section 104 of the Securities and Futures Ordinance (Cap. 571) or are bona fide widely held investment schemes which comply with the requirements of supervisory authorities within acceptable regulatory regimes exempted from profits tax under section 26A(1A) of the Inland Revenue Ordinance (Cap. 112).

A business undertaking for general commercial or industrial purpose is not a fund. Such business undertakings include those engaging in –

(a) a commercial activity, involving the purchase, sale and/or exchange of goods or commodities, and/or supply of services;

(b) an industrial activity, involving the production of goods or construction of properties;

(c) property development or property holding;

(d) finance (banking, providing capital, leasing, factoring or securitisation);

(e) insurance;

(f) construction or direct acquisition of infrastructure facilities; and/or

(g) making direct investments that derive rent, royalties or lease payments.

For the avoidance of doubt, a fund will not be regarded as "a business undertaking for general commercial or industrial purpose" if it engages in qualifying transactions.

For the definition of ***fund*** above, ***property*** (財產) includes—

(a) money, goods, choses in action and land, whether in Hong Kong or elsewhere; and

(b) obligations, easements and every description of estate, interest and profit, present or future, vested or contingent, arising out of or incident to property as defined in paragraph (a).

Annex B

Proposed list of qualifying assets

(a) Securities

(b) Shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a private company (regardless of whether the company is incorporated in or outside Hong Kong)

(c) Futures contracts

(d) Foreign exchange contracts

(e) Deposits other than those made by way of a money-lending business

(f) Bank deposits

(g) Certificates of deposits

(h) Exchange-traded commodities

(i) Foreign currencies

(j) Over-the-counter derivative products

(k) Shares of private companies co-invested by partner funds of the Innovation and Technology Venture Fund ("ITVF") and the ITVF[1]

[1] The ITVF, under the oversight of the Innovation and Technology Commission, was launched in 2017 to stimulate private investment in local innovation and technology ("I&T") start-ups. The ITVF co-invests with partner venture capital funds (i.e. the partner funds) in local I&T start-ups which meet certain pre-set criteria for "Eligible Local I&T Start-up". Given that the co-investment is subject to the control and monitoring of the ITVF scheme, transactions in such private companies by the partner funds co-investing with the ITVF will not be subject to the three tests at paragraph 13 of the main paper. Yet, investment in other private companies by the partner funds on their own without co-investment with the ITVF will be subject to the three tests.

Annex C

Tests on profits tax exemption eligibility for profits generated from transactions in private companies by funds