HONG KONG TAX ALERT

ISSUE 14 | July 2017

Profits Tax exemption for privately offered open-ended fund companies

Summary

The Hong Kong Government has published a Bill to confer a Profits Tax exemption on Hong Kong privately offered open-ended fund companies (OFCs).

The Bill will enable asset managers to set up a privately offered fund as an OFC in Hong Kong which will not be subject to tax. This is an encouraging policy initiative to promote the asset management industry in Hong Kong, although there are some areas of uncertainty under the Bill which could impact its effectiveness.

Legislation expected to be enacted in 2018

The Financial Secretary announced in the 2017-18 Budget a proposal to extend the Profits Tax exemption to Hong Kong privately offered open-ended fund companies (OFCs). On 23 June 2017, the Hong Kong Government published a Bill to implement this exemption. This is part of a wider initiative to promote Hong Kong as an investment asset management hub.

Under the Bill, a privately offered OFC will be exempt from Profits Tax in respect of profits from qualifying transactions where the following conditions are satisfied:

1. the OFC is a Hong Kong resident;

2. the OFC is not closely held;

3. the OFC carries out transactions in permissible asset classes (there is a de minimis exception - the OFC may invest in non-permissible asset classes up to a maximum of 10% of the total gross asset value of the fund); and

4. the transactions are carried out through or arranged by a “specified person” (which means a company licensed by the SFC) or an authorised financial institution).

Analysis

The exemption will apply to OFCs that are resident in Hong Kong. Residence for this purpose is determined by the OFC’s place of central management and control. (If the OFC is resident outside Hong Kong, it may nevertheless qualify for the existing offshore funds exemption, where the required criteria for that exemption are met.)

The Bill also proposes strict qualifying conditions pertaining to investors in the OFC. The qualifying conditions differ depending on whether or not the OFC has a “qualifying investor”.

A "qualifying investor" in relation to an OFC means any of the following (subject to meeting certain requirements):

- an institutional investor;
- a collective investment scheme under the Securities and Futures Ordinance;
- a registered scheme (or its constituent fund) under the Mandatory Provident Fund Schemes Ordinance;
- an entity established to provide retirement, disability or death benefits to beneficiaries which are current or former employees;
- a government entity; or
- a fund established by a governmental entity, international organisation, central bank or the Hong Kong Monetary Authority to provide disability or death benefits.

If the OFC has at least one qualifying investor, the OFC will not be closely held where:

- the OFC has at least 1 qualifying investor, and at least 5 investors in total;
- the qualifying investor has a participation interest of at least HK$200 million, and at least 4 other investors each have a participation of at least HK$20 million;
- the participation interest of each investor (not being a qualifying investor) should not exceed 50% of the OFC's issued share capital; and
- the participation interest of the OFC's originators and associates do not exceed 30% of the OFC's issued capital.

If the OFC does not have a qualifying investor, the OFC will be considered not closely held where:

- the OFC has at least 10 investors;
- at least 10 of the investors each have a participation of at least HK$20 million;
- the participation interest of each investor (not being a qualifying investor) does not exceed 50% of the OFC's issued share capital; and
- the participation interest of the OFC's originators and associates do not exceed 30% of the OFC's issued capital.

The permissible investment classes include securities, futures contracts, foreign exchange contracts, deposits made with a bank, foreign currencies, certificates of deposits, cash and OTC derivatives products. Trading receipts from "incidental" transactions are limited to 5% of the total trading receipts of the OFC.

The Bill also contains the following anti-avoidance measures to prevent potential abuse.

- The OFC must continue to meet the not closely held test for 24 months after the first 24 month period. If not, the OFC will be taxable retrospectively from its start-up date.
- Where the OFC invests in non-permissible asset classes and the 10% de minimis threshold is not exceeded, only the profits derived from transactions in non-permissible asset classes will be subject to tax. If the 10% de minimis threshold is exceeded, the exemption will be lost entirely and all of the OFC's profits could be subject to tax.
- Similar to the existing offshore fund exemption, a resident person who, alone or jointly with his associates, holds a direct or indirect beneficial interest of 30% or more in a tax-exempt OFC, will be taxable on his or her share of the OFC's profits.

- Finally, the Bill proposes that managers and investment advisors will be taxed on dividends they receive from an OFC that is not tax exempt where the income is considered to be consideration or remuneration for their services in Hong Kong.

KPMG observations

The legislative process may take a few months to complete.

The Bill will enable asset managers to set up a privately offered fund as an OFC in Hong Kong which will not be subject to tax. This is an encouraging policy initiative to promote the asset management industry in Hong Kong, although we would highlight that there are some areas of uncertainty under the Bill which could impact its effectiveness.

In particular, we note the following items in the Bill:

- There may be concerns as to whether an OFC can satisfy all the not closely held conditions at all relevant times in order to enjoy the tax exemption.
- If the not closely held conditions are not met, the OFC would be treated as taxable from the time it receives its first investor. However, the IRD has discretion to deem the OFC to continue to qualify for exemption in certain circumstances.
- The Bill is silent on the stamp duty implications with regards to an OFC. The allotment and cancellation of shares of an OFC are not subject to stamp duty, but any transfer of the OFC's shares would be subject to stamp duty. A full exemption from stamp duty should be considered.

Of more concern, the Bill includes a provision that deems dividends from a non-exempt OFC to be taxable to the extent they are regarded as consideration or remuneration for services rendered in Hong Kong. This is a simplistic approach to address the issue of carried interest and performance fees in Hong Kong.

The proposed treatment in the Bill does not take into account the circumstances giving rise to a carry distribution in connection with an investment in the OFC. Whether or not a carried interest is a genuine investment return or remuneration for services rendered is a fact specific question that has to be considered on a case-by-case basis. There is also no mention of the right of an OFC to deduct dividends that are taxed in the hands of the manager or advisor.

The taxation of carried interest and fees in Hong Kong has been a contentious issue. There are obvious concerns that this new rule could have broader implications for the asset management industry in Hong Kong.

On a final note, asset managers can consider setting up a non-resident fund that will qualify for the somewhat broader offshore funds exemption. Also, a publicly-offered fund (registered with the SFC) would qualify for a blanket tax exemption. The new exemption is designed to enable a particular type of fund (an OFC) to be resident in Hong Kong, which would enable its management to be conducted in Hong Kong. Time will tell whether the Hong Kong Government will consider extending the more general offshore funds exemption to all resident funds.

KPMG has a dedicated team of tax professionals focused on servicing fund clients who have been actively involved in the Hong Kong Government consultation process and have extensive experience in assisting clients to establish fund structures. Our team would be pleased to meet with you to discuss the impact of the changes on your business and what you can look to do in the lead-up to these changes coming into effect.

Contact us:

Lewis Y. Lu
Head of Tax, KPMG China
Tel: +86 21 2212 3421
lewis.lu@kpmg.com

Curtis Ng
Head of Tax, Hong Kong
Tel: +852 2143 8709
curtis.ng@kpmg.com

Corporate Tax

Chris Abbiss
Head of Real Estate Tax, KPMG China
Tel: +852 2826 7226
chris.abbiss@kpmg.com

Stanley Ho
Principal
Tel: +852 2826 7296
stanley.ho@kpmg.com

Charles Kinsley
Principal
Tel: +852 2826 8070
charles.kinsley@kpmg.com

Alice Leung
Partner
Tel: +852 2143 8711
alice.leung@kpmg.com

John Timpany
Partner
Tel: +852 2143 8790
john.timpany@kpmg.com

Matthew Fenwick
Director
Tel: +852 2143 8761
matthew.fenwick@kpmg.com

Sandy Fung
Director
Tel: +852 2143 8821
sandy.fung@kpmg.com

Ivor Morris
Director
Tel: +852 2847 5092
ivor.morris@kpmg.com

Natalie To
Director
Tel: +852 2143 8509
natalie.to@kpmg.com

Michael Olesnicky
Special Advisor
Tel: +852 2913 2980
michael.olesnicky@kpmg.com

M & A Tax

Darren Bowdern
Head of Financial Services Tax, KPMG China
Tel: +852 2826 7166
darren.bowdern@kpmg.com

Yvette Chan
Principal
Tel: +852 2847 5108
yvette.chan@kpmg.com

Benjamin Pong
Principal
Tel: +852 2143 8525
benjamin.pong@kpmg.com

Malcolm Prebble
Principal
Tel: +852 2685 7472
malcolm.j.prebble@kpmg.com

China Tax

Karmen Yeung
Partner
Tel: +852 2143 8753
karmen.yeung@kpmg.com

Daniel Hui
Principal
Tel: +852 2685 7815
daniel.hui@kpmg.com

Adam Zhong
Principal
Tel: +852 2685 7559
adam.zhong@kpmg.com

Travis Lee
Director
Tel: +852 2143 8524
travis.lee@kpmg.com

Steve Man
Director
Tel: +852 2978 8976
steve.man@kpmg.com

Transfer Pricing

John Kondos
Seconded Partner
Tel: +852 2685 7457
john.kondos@kpmg.com

Lu Chen
Principal
Tel: +852 2143 8777
lu.l.chen@kpmg.com

Irene Lee
Director
Tel: +852 2685 7372
irene.lee@kpmg.com

Global Mobility Services

Barbara Forrest
Principal
Tel: +852 2978 8941
barbara.forrest@kpmg.com

Murray Sarelius
Principal
Tel: +852 3927 5671
murray.sarelius@kpmg.com

David Siew
Principal
Tel: +852 2143 8785
david.siew@kpmg.com

Erica Chan
Director
Tel: +852 3927 5572
erica.chan@kpmg.com

Kate Lai
Director
Tel: +852 2978 8942
kate.lai@kpmg.com

US Tax

Wade Wagatsuma
Head of US Corporate Tax, KPMG China
Tel: +852 2685 7806
wade.wagatsuma@kpmg.com

Becky Wong
Director
Tel: +852 2978 8271
becky.wong@kpmg.com

Indirect Tax

Lachlan Wolfers
Head of Indirect Tax, KPMG China Regional Leader, Asia Pacific Indirect Tax
Tel: +852 2685 7791
lachlan.wolfers@kpmg.com

kpmg.com/cn