KPMG

China Tax Alert

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New profits tax exemption for private funds provides welcome boost to Hong Kong's fund industry

Summary

On 7 December 2018, the Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018 was introduced to the Hong Kong Legislative Council which contains a new comprehensive exemption from Profits Tax for private funds operating in Hong Kong.

The new legislation contains two exemptions from Hong Kong profits tax, being:

(i) an exemption for funds that meet certain qualifying criteria; and

(ii) an exemption for 'Special Purpose Entities' established by a qualifying fund.

The broad nature of the new exemption will provide opportunities for funds with operations in Hong Kong to simplify their current operating protocols and undertake more investment related activities in Hong Kong. This is a welcome development for the Hong Kong's fund industry.

The Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018 was introduced to the Hong Kong Legislative Council on 7 December 2018 containing a new comprehensive exemption from Profits Tax for private funds operating in Hong Kong.

The stated objectives for introducing the new legislation is to address some concerns raised by the OECD and European Union in relation to Hong Kong's existing offshore funds exemption as well as for the overall promotion of the Wealth and Asset Management industry in Hong Kong.

The need for the comprehensive exemption arises through both practical and technical difficulties with the key existing Profits Tax exemptions for funds (Offshore Funds exemption which was revised in 2015 and the exemption for Open-ended Fund Companies ("OFCs") which was introduced earlier this year) which has resulted in many funds with investment teams in Hong Kong being reluctant to place any reliance on those exemptions. Overall the new comprehensive exemption represents a significant step forward and should contribute to the Government's long stated objective of further developing the asset and wealth management industry in Hong Kong. It is also something that should be welcomed by the funds industry, in particular, private equity participants.

One notable and very significant change is to remove tainting provisions that have applied to the previous iterations of the fund exemptions. This means that if a fund now has a particular portfolio investment that does not satisfy the qualifying conditions, it will no longer preclude the fund from relying on the exemption for all other investments. This is a big step forward and should allow fund organizations to bring more of their key investment management activities onshore without running the risk of not being able to rely on the exemption for all investments as a result of inadvertently making one non-qualifying investment.

Another key feature of the exemption is to combine separate exemptions for non-resident persons (including offshore funds) and an exemption for OFCs incorporated in Hong Kong. The existing non-resident person's exemption remains in place for persons other than funds. This is a welcome development as there was real concern about the impact on the wider wealth management industry from a proposed repeal of this exemption.

Our observation has been that interest in OFCs for private funds has been very limited to date due to both the burden associated with obtaining the required regulatory approvals and some onerous aspects of the Profits Tax exemption for OFCs. The new legislation repeals in full the OFC Profits Tax exemption and incorporates OFCs into the new comprehensive private fund tax exemption. In doing so, the onerous qualifying conditions for the OFC tax exemption have fallen away which is a positive move. However, the regulatory aspects may still continue to limit the use of OFCs in practice.

A further welcomed move is that the initial proposal to codify the taxation (or at least partial taxation) in Hong Kong of carried interest has not been included in the draft legislation. Similar provisions where included in the legislation enacted earlier this year to introduce the OFC Profit Tax exemption and were initially expected to be included in this legislation. Significant lobbying from the private equity industry has taken place in respect of this issue and it is pleasing that Government officials appear to have taken on board the likely impact that introducing such a change would have had on decisions by private equity funds on establishing and maintaining investment teams in Hong Kong.

Brief history of Hong Kong tax exemptions for Funds

The Revenue (Profits Tax Exemption for Offshore Funds) Ordinance 2006 first introduced a profits tax exemption for offshore funds that satisfied certain qualifying conditions. This exemption applied unchanged for a number of years but did not cater for the types of investments made by private equity funds. This position changed in 2015 when new legislation was enacted to extend the existing exemption to offshore private equity funds. Separately, legislation was enacted earlier this year to provide a profits tax exemption to OFCs incorporated in Hong Kong. The latter exemption was to supplement amendments to the Companies Ordinance to allow the use of OFCs in Hong Kong.

Overall the existing fund exemptions have worked well for some types of funds operating in Hong Kong, in particular, hedge funds. However, many private equity funds have continued to be reluctant to place reliance on the tax exemptions. As such, the new exemption should be welcomed by the majority of industry participants.

Key features of new exemption

The new legislation contains two exemptions from Hong Kong profits tax. These being:

- An exemption for funds that meet certain qualifying criteria; and
- An exemption for 'Special Purpose Entities' ("SPE") established by a qualifying fund

In addition, the existing exemption for offshore funds continues to apply for any entities that do not satisfy the qualifying criteria for the new funds exemption.

The exemption for OFCs will be repealed in full with the key aspects being incorporated into the new legislation.

The new exemptions are quite broad and apply to both resident and non-resident funds, transactions undertaken by SPEs established by those funds, and most types of investments typically contemplated by private equity or other forms of alternative funds.

The wide range of potential funds that could seek to rely on the exemption is certainly a positive move and an improvement on the status quo. The specific inclusion of Sovereign Wealth Funds within the 'fund' definition is a good example of this as is the potential ability for pension funds and other forms of single investor funds to rely of the exemption.

However, as is noted below further clarity is needed on the ability of the latter to categories to qualify as a 'fund'.

KPMG anticipates that the broad nature of the new exemption will provide opportunities for funds with operations in Hong Kong to simplify their current operating protocols and undertake more investment related activities in Hong Kong. This is clearly a positive move and is something that the fund industry has been seeking for some time. It should also make it much easier for funds looking to establish new operations in Hong Kong. There are also potential opportunities for funds to invest in new classes of assets in Hong Kong (e.g., infrastructure assets) without the risk of additional tax on the investment returns received by the fund.

Remaining areas for improvement

While overall, the new exemption is a significant step forward, there are a number of issues that should be addressed to ensure that funds can obtain sufficient comfort to place reliance on the new exemption. Some of these issues are not new and we encourage the Government to look to address these in the final legislation rather than addressing them in guidance. Past experience suggests that governance procedures adopted by medium and large sized funds (i.e., the types of funds that the Hong Kong SAR Government would like to attract to Hong Kong), will place greater emphasis on the legislative wording than interpretive guidance issued by tax authorities, particularly if the guidance does not clearly address their specific concerns. Examples of some of the areas of uncertainty include:

- The status of listed security investments held by an SPE of a fund. For example, if a private equity fund makes a range of listed and non-listed investments and uses SPEs to hold those investments, the SPE exemption would appear not to apply to the listed investments. This is because the SPE can only hold and administer investments in private companies. However, the listed securities should be exempt if held directly by the fund, but legal and other non-tax considerations would often preclude this.

  There does not appear to be any clear policy reason why listed investments or other non-corporate investments (e.g., partnership, trusts) should not be covered by the SPE exemption and we would encourage Government officials to amend the legislation to reflect this as opposed to addressing the issue through guidance (note, this is an example of an issue where funds are unlikely to be able to place reliance on guidance that is not consistent with the content of the legislation).
- Both the Fund exemption and SPE exemption are subject to carve outs in relation to investments held for less than two years. For any such investments, the exemption does not apply where the Fund or SPE has control over a portfolio company and that company has (directly or indirectly) 'short term assets', the value of which exceeds 50% of the value of that company's total assets.

  The definition of short term assets is quite broad and could inadvertently capture a portfolio company of a fund with trading stock or other trading assets that represent more than 50% of the total value of that portfolio company regardless as to the location of that business or those assets. It is unclear what arrangements these provisions are trying to address, but at a minimum it should be limited to portfolio companies with assets in Hong Kong and not global assets.
- The legislation specifically mentions that Sovereign Wealth Funds can qualify as 'funds' for the purposes of the new exemption. However, it is less clear on the status of pension plans or other single investor investment vehicles. It appears that the intention is that the exemption should cover these types of investment vehicles, but further clarification on this aspect would be helpful.

KPMG observations

The introduction of the new legislation represents a positive step forward for the Government's efforts to promote the asset and wealth management activity in Hong Kong.

At first glance, the new comprehensive profits tax exemption for private funds appears to be something that Private Equity funds with operations in Hong Kong could look to place reliance upon. This should help to alleviate the need for such funds to follow detailed operating protocols and structure investments in such a way that they would not expose the fund to Hong Kong tax. This should help to place Hong Kong on a level playing field with other fund centres which provide clear and comprehensive tax exemptions for funds with operations in those locations.

However, there are still some areas where the draft legislation could be improved and we hope that Government officials are willing to make changes to the draft legislation prior to enactment to rectify these aspects. There is no doubt that doing so will help with the Government's stated goal of promoting the asset and wealth management industry in Hong Kong.

KPMG has a dedicated team of tax professionals focused on servicing fund clients who have extensive experience with establishing fund structures. Our team would be pleased to meet with you to discuss the impact of the changes on your business.

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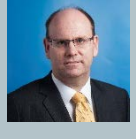

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