

Asset Management – Tax update

A new Limited Partnership Fund regime for Hong Kong

Summary

The Limited Partnership Fund Bill is an important development for the funds industry in Hong Kong as the Hong Kong Government looks to encourage funds to domicile here. The proposed Limited Partnership Fund (LPF) regime will provide a comparable regulatory framework to other jurisdictions commonly used by Asian focused funds and should cement Hong Kong's position as Asia's leading Asset Management hub.

The introduction of the Limited Partnership Fund Bill is one of the Hong Kong Government's flagship initiatives and a major development in continuing to promote Hong Kong as Asia's leading Private Equity hub. This follows extensive consultation by the Government with the asset management industry in Hong Kong with the objective of introducing an LPF regime that is on par with the more established domicile jurisdictions.

Asian focused funds have always looked to Hong Kong as a regional hub in which to situate their investment teams. However, these funds have typically established or domiciled their collective investment vehicles in jurisdictions such as the Cayman Islands because such jurisdictions provide a regulatory framework with which investors are familiar, and a tax neutral investment platform which allows investors to be taxed on investment returns in their home jurisdictions.

We anticipate that the LPF regime will prove beneficial to asset managers looking for an alternative jurisdiction to establish their offshore funds.

Key features of the regime

Establishing an LPF The fund must be constituted by a limited partnership agreement with one general partner and at least one limited partner. Partners in the fund cannot just consist of corporations in the same group of companies, although there is a two year window to register the fund and raise third party capital. The fund must register with the Registrar of Companies as an LPF and maintain a registered office in Hong Kong. The Fund is not required to be authorised by the SFC.

Who can be the General Partner (GP)? Broadly, the general partner may be a natural person at least 18 years old, a Hong Kong private limited company, a registered non-Hong Kong company, a limited partnership registered under the Limited Partnership Ordinance or a limited partnership established outside of Hong Kong.

Appointment of investment manager The GP must appoint an investment manager, or if it chooses, the GP can perform the role of the investment manager. The fund manager may be required to be licensed by the SFC if it engages in an activity that falls under the remit of the SFC.

Appointment of auditor, responsible person, ensure proper custody The GP must appoint a Hong Kong registered auditor and ensure there are proper custody arrangements for the assets of the fund. The GP must also appoint a responsible person (authorised institution, licensed corporation, accounting professional, or legal professional) to carry out anti-money laundering and counter-terrorist financing functions. Records must be made available for inspection by Hong Kong Government bodies (but not for public inspection), and an annual return must be filed with the Registrar.

Migration of existing funds Existing funds registered under the Limited Partnership Ordinance who register as an LPF are deemed not to have been dissolved, and therefore no change in legal or beneficial ownership of the assets of the fund should arise. However, no provisions have been introduced to facilitate a simple legal migration of non-Hong Kong incorporated GPs to become Hong Kong incorporated GPs.

Dissolution An LPF may ordinarily be dissolved in accordance with the limited partnership agreement without a court order, although a notification of dissolution must be filed with the Registrar. However, a court ordered dissolution may occur on application by a partner in the fund or a creditor in prescribed circumstances. Tax clearance from the IRD will be required before a fund can be dissolved.

Tax treatment of an LPF

An LPF, like any other private equity fund, will qualify as exempt from tax if it satisfies all of the conditions of the existing unified funds exemption (UFE). There is no new or separate exemption that will apply to an LPF.

Whilst the proposed LPF regime should put Hong Kong on par with other leading regulatory regimes for fund groups, the ability for the regime to entice fund groups to domicile in Hong Kong will ultimately depend on the attractiveness of domestic tax exemptions in Hong Kong for the LPF fund.

A key consideration by limited partners in deciding whether to commit capital to a fund established in Hong Kong is for the LPF not to be subject to direct taxation in Hong Kong. Having a fund domiciled in Hong Kong with its investment team should also align the fund with the OECD's Base Erosion and Profit Shifting (BEPS) initiative and thereby make it easier for fund groups to access tax treaty benefits into the jurisdictions they invest.

Most LPFs should satisfy the exemption and qualify as exempt, but for some, the current UFE may not apply to the Fund's investment gains, or the conditions may simply be viewed as more onerous to comply with than in comparable jurisdictions that exempt private equity funds from direct taxation. To ensure the success of the LPF regime and put Hong Kong's overall fund regime ahead of other jurisdictions, modifications to the UFE and the broader tax regime in Hong Kong are required to achieve this, including:

- Broadening the asset classes to include all investment gains made by a fund, including treating interest income as qualifying income. Singapore has amended its fund exemption provisions to specifically cater for credit funds to provide a specific exemption for interest income which has resulted in many of those fund groups establishing their Asian investment platforms in Singapore instead of Hong Kong.
- Ensuring special purpose investment entities (SPEs) of the LPF can obtain tax residence certificates (TRCs). The inability to establish substantive activities in a Hong Kong SPE has been problematic when applying for TRCs from the IRD. The limited substance allowed in the SPEs at times also impedes the ability for SPEs to be eligible for tax treaty benefits with jurisdictions into which investments are made. Where the LPF itself is able to avail of the benefits under the UFE, its investment SPEs should automatically be entitled to the same benefits.
- Addressing taxation of Carried Interest given the Inland Revenue Department's position on how Carried Interest should be taxed (click [here](#)). In this regard, the Government has done well to put this issue firmly on the agenda in its recent budget. It is expected that draft Carried Interest tax provisions will be introduced very shortly.

Looking ahead

Jurisdictions such as Singapore have long been taking a proactive approach in expanding the types of investments covered under its fund exemption tax provisions, and ultimately encouraging funds to domicile their investment platforms and operations there. Having said this, Hong Kong has more recently been undertaking a range of initiatives to encourage asset management groups maintain operations in Hong Kong. The Open Ended Fund regime now allows funds such as Hedge Funds (amongst others) to domicile in Hong Kong.

The introduction of the LPF regime will put Hong Kong firmly in the mix as an alternative location and on par with comprehensive regulatory frameworks elsewhere, and as such should provide an alternative location for GPs and assets managers to domicile their funds. Importantly, GPs being able to appoint onshore or offshore fund managers, or alternatively act as the manager of the LPF themselves if they so choose, should greatly help simplify overall fund structures.

The Government should be commended for introducing this initiative. If the Government is able to implement the changes necessary to bring the fund tax exemption in line with other jurisdictions vying as a regional PE headquarters location then the LPF regime should be boon for the asset management industry in Hong Kong.

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