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LEGAL UPDATE

International tax cooperation spurs key development of the Hong Kong asset management industry – level playing field for onshore and offshore funds

Overview

In December 2017, the Council of the European Union (EU) identified certain ring-fencing features in Hong Kong's profits tax exemption regime, which are considered discriminatory and isolated from the domestic economy. In order not to be labelled as a non-cooperative jurisdiction by the EU Council, Hong Kong committed to addressing this concern by considering appropriate modifications and proposing legislative amendments by the end of 2018.

On 7 December 2018, the Hong Kong Government Gazette published new and self-contained provisions in the Inland Revenue Ordinance (Cap. 112) (IRO) that will allow all funds operating in Hong Kong, regardless of their location of central management and control, their size or the purpose that they serve, to enjoy profits tax exemption for transactions in specified assets subject to meeting certain conditions. The bill will be introduced into the Legislative Council on 12 December 2018, and when adopted, will come into operation on 1 April 2019.

Once the proposed amendments are adopted, more funds are expected to become eligible for enjoying tax exemption benefits in Hong Kong. This is a significant development that will create a level playing field for tax for all funds operating in Hong Kong, whether domiciled in or outside Hong Kong, and whether operating or managed in or from Hong Kong.

The change is expected to enhance Hong Kong's position as an international asset and wealth management centre, and could attract more professional asset management and related services to be brought into and be carried out from Hong Kong.

Recent developments

Earlier this year, in the 2018-19 Budget Speech of the Financial Secretary, it was announced that the Government will review the existing tax concession arrangements applicable to the fund industry with regard to international requirements on tax co-operation. As such, the Financial Services and the Treasury Bureau ("**FSTB**"), together with the Inland Revenue Department ("**IRD**"), the Hong Kong Monetary Authority ("**HKMA**") and the Securities and Futures Commission ("**SFC**"), have reviewed the current profits tax exemption regime and prepared a proposal for the legislator's consideration. On 5 November 2018, the FSTB presented its proposal to Hong Kong Legislative Council with a view to addressing the ring-fencing concerns of the EU. Subsequently, as advised by the Executive Council and ordered by the Chief Executive on 4 December 2018, the Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018 (the "Bill") was published in the Gazette on 7 December 2018.

Current tax exemption for funds

Broadly speaking, under the current law, the potential applicability of the profits tax exemption with respect to funds can be categorised as follows:

Type of fund	Offshore	Onshore
Public offered	Tax exempt as an authorised fund	Tax exempt as an authorised fund
Privately offered	Offshore funds and offshore private equity funds investing in overseas private companies are potentially tax exempt	(Only) open-ended fund companies ("OFC") are potentially tax exempt

As noted by the Council of the EU, Hong Kong applies profits tax exemption only to *offshore* funds and *offshore* private equity funds, which requires such funds to have the central management and control outside Hong Kong, and to not carry on any business in Hong Kong other than "specified transactions" and incidental transactions relating thereto.

Furthermore, in order to benefit from the tax exemption, offshore funds may only invest in "excepted private companies" (which are, broadly speaking, *overseas* companies of which not more than 10% of the value of their assets consists (directly or indirectly) of Hong Kong immovable property, and which do not carry on (directly or indirectly) any business in Hong Kong).

As such, the EU is of the view that the current profits tax regime for funds are ring-fenced from the domestic economy and, therefore, may constitute harmful tax practice.

The highlights of the proposal

The highlights of the FSTB's proposal include the following improvements, inter alia;

Removal of ring-fencing at the fund level

- re-defining "fund" to include all types of funds, irrespective of the location of their central management and control, so that both privately offered onshore and offshore funds can potentially enjoy the benefits of profits tax exemption;

- leaving out the minimum fund size requirement (which is currently a requirement for onshore funds and potentially an obstacle to benefit from the tax exemption under the OFC regime).

Removal of ring-fencing at investments level

- the freedom to invest in both Hong Kong and foreign incorporated private companies without jeopardizing the application of the exemption, provided that (i) the fund does not hold (directly or indirectly) more than 10% of its assets in immovable property in Hong Kong and (ii) the shares in the private companies have been held for at least 2 years;

- or if the fund were to dispose of its shares in a private company within 2 years, the fund may still avail of the tax exemption where (a) the fund does not have a controlling stake in the private company, or (b) the latter does not hold more than 50% of its assets for less than 3 years ("short term assets");

- the flexibility to invest in both "qualifying assets" and "non-qualifying assets" without jeopardizing the application of the tax exemption of the fund in respect of all investments, where if the fund engaged in any transaction that does not qualify as a "specified transaction" or an incidental transaction relating thereto, only the Hong Kong sourced profits from transactions in non-qualifying assets would be held liable to profits tax without "tainting" the exemption of the entire fund for that year of assessment.

The changes would allow all funds that meet the definition of "collective investment scheme" to potentially be eligible for profits tax exemption, provided a "specified person" (i.e. licensed to carry on a regulated activity under the Securities and Futures Ordinance) is engaged to arrange or carry out its transactions in Hong Kong, or the fund is a "qualifying fund" (with at least five investors who invest more than 90% of the fund's capital commitments, and distribution of the fund's net proceeds to the originator and its associates should not exceed 30%).

Our observations

The FSTB noted that the LegCo Panel on Financial Affairs has been briefed on the proposal and its members are generally in support of the proposal. If it may be fairly assumed that the intention and spirit of the FSTB's proposal will be accepted by the Legislative Council for the Bill to be passed, this would bring about a highly positive step towards the growth and competitiveness of the asset management industry in Hong Kong. With the passage of the Bill, the FSTB expects more funds to domicile and/or be managed in Hong Kong, which should drive demand for related professional services locally.

At Vivien Teu & Co LLP, we consider it a welcome development if all funds currently eligible for the profits tax exemption would continue to be exempt under the amended regime whilst becoming resident or having central management and control in Hong Kong. With the removal of the ring-fencing features of the current tax exemption, it is likely to have a positive effect for the promoters and investment professionals of private equity, venture capital and real estate funds to consider locating their activities, decision making, management and control in Hong Kong.

Contact Details

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