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Hong Kong Tax Analysis

Inland Revenue Department issues guidance on unified tax exemption regime for funds

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Introduction

Hong Kong's Inland Revenue Department (IRD) issued Departmental Interpretation and Practice Notes No. 61 (DIPN 61) on 30 June 2020 to clarify the provisions of the Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Ordinance 2019 (the unified regime). The unified regime came into effect as from 1 April 2019 and extends the profits tax exemption to **all funds**, **irrespective of whether or not the central management and control is exercised in Hong Kong**, subject to certain conditions. In this Tax Analysis, we highlight several key areas where DIPN 61 has provided additional guidance on the interpretation of the legislation.

Recap of the unified regime

Three conditions must be met for an investment fund to qualify for the tax exemption under the unified regime:

- The entity must qualify as a "fund" for the purpose of the exemption;
- The profits must be derived from qualifying transactions or incidental transactions that are subject to a 5% threshold. In the context of private equity funds, additional conditions must be met for transactions in private companies to be tax-exempt; and

- The qualifying transaction must be carried out or arranged in Hong Kong by a “specified person”, which includes a corporation licensed by the Securities and Futures Commission. If not, the fund must meet the definition of a "qualified investment fund".

For more details on the unified regime, please refer to our Tax Newsflash Issue 82.

Definition of "fund"

Key concepts - features of a "collective investment scheme"

To qualify for the tax exemption, a fund must meet the relevant definition under the unified regime. The definition broadly is aligned with that of collective investment scheme in Section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance. In DIPN 61, the IRD’s interpretation is essentially that arrangements with **the characteristics of pooled investment** are brought within the meaning of "fund". The unified regime excludes from the "fund" definition an arrangement where each participating person is a corporation in the same group of companies as the operator of the arrangement (an excluded group scheme). There were concerns within the industry that where a fund is fully funded by seed capital from the fund's general partner or fund manager, or their affiliates in the initial launch phase, it may not qualify for the tax exemption. DIPN 61 appears to have addressed this concern as it clarifies that an excluded group scheme refers to an arrangement or structure within a corporate group, and does not relate to situations where a fund is launched in a year of assessment with a single seed investment by an affiliate of the investment manager. On the other hand, DIPN 61 also states that under “very special circumstances”, an arrangement may be accepted by the Commissioner as a "fund" even where it has one investor at a certain point in time within a year of assessment (e.g., during the start-up period or winding-down period).

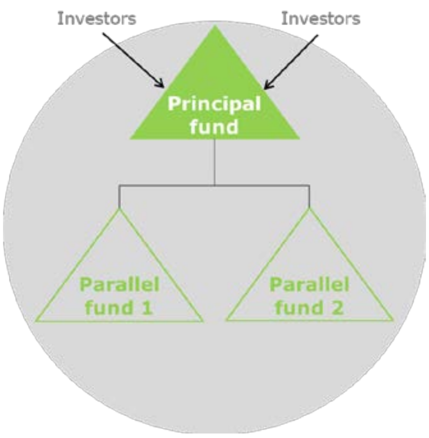
Deloitte's observations

DIPN 61 does not elaborate on what may constitute very special circumstances, or the factors/criteria that the IRD will consider in determining whether a fund with only one investor may be accepted as a "fund" for the purpose of the unified regime. Meanwhile, the IRD also mentions that an arrangement intended to have a single investor is unlikely to be a "pooled" arrangement, and therefore unlikely to qualify as a "fund". Were the IRD to deny any fund that is intended to have a single investor the tax exemption under the unified regime, it appears that the typical Fund-Of-One structure used by institutional investors (e.g., pension funds and sovereign wealth funds) would be unable to benefit from the exemption. Key institutional investors frequently form Fund-of-One structures that also play a vital role in the private equity market. We would like to see the IRD adopt a more liberal interpretation of "fund" so that Fund-Of-One structures established for genuine commercial reasons would qualify for the tax exemption, to allow for greater structural flexibility to attract more institutional investors to Hong Kong.

Multi-vehicle fund structures – a single fund or separate funds?

To address the use of complex and multi-vehicle fund structures (e.g., master-feeder structures, parallel funds, etc.) in the market, the IRD explains in DIPN 61 that it will consider all the facts, including the constitutive documents, the investment mandate, and the management agreements, in deciding whether there is one or more than one fund for the purpose of the unified regime. The following examples are cited in DIPN 61:

Example 1: Principal fund and its parallel funds



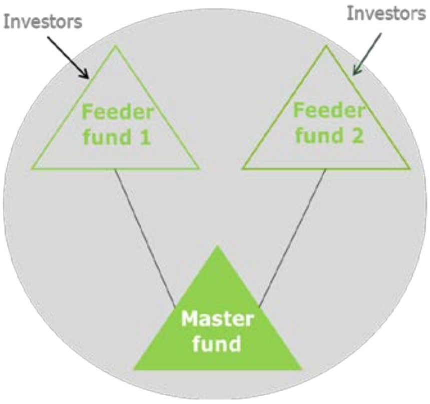
Key features

- The fund agreements substantially are the same;
- The size of the funds is aggregated for the purpose of any overall fund size cap; and
- Investors are aggregated for the purpose of voting under the fund agreements.

Deloitte's observations

The principal fund and two parallel funds likely would be **considered as a single fund**. As such, although each parallel fund has only the principal fund as its sole investor, the funds together could qualify as a "fund" for purposes of the tax exemption.

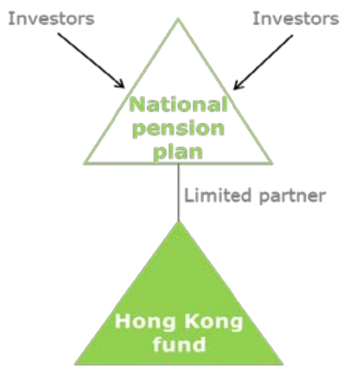
Example 2: Master-feeder structure



Key features
- The feeder funds do not have an independent existence; and
- The feeder funds are set up purely to address the needs of investors from different jurisdictions for investment into the master fund.

Deloitte's observations
Per DIPN 61, it may be appropriate to regard the master fund and feeder funds **as a single fund**.

Example 3: Pension fund

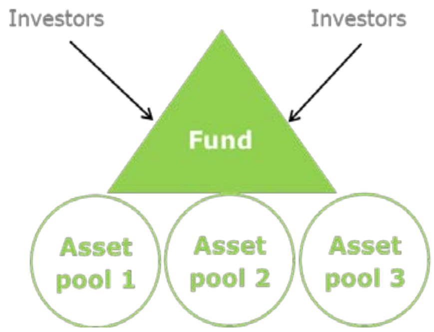


Key features
- The pension fund is regulated by legislation;
- The pension fund is likely to operate great independence; and
- The participants and beneficiaries of the pension fund would have no control or influence over the management of the investments made by the pension fund.

Deloitte's observations
The IRD indicates in DIPN 61 that **the national pension plan would constitute one investor** for determining whether the Hong Kong fund qualifies as a "fund" for the purpose of the tax exemption.

It is unclear if there are any circumstances under which the pension fund and the Hong Kong fund can otherwise be considered a single fund. If the Hong Kong fund is to be regarded as a separate fund, as mentioned above, this type of Fund-Of-One structure would not be accepted by the IRD as a "fund" that qualified for the tax exemption under the unified regime. We suggest the IRD interpret the term "fund" broadly so that genuine Fund-Of-One structures set up by institutional investors are not denied the exemption.

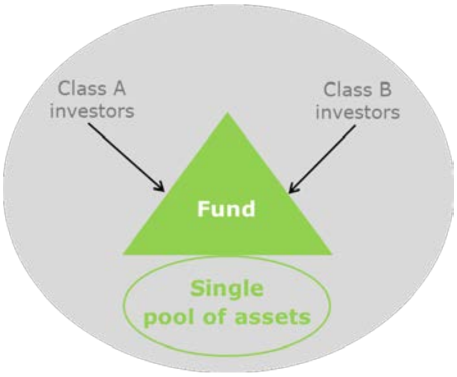
Example 4(1): Separate pools of assets



Key feature
- An arrangement involves a number of separate pools of assets.

Deloitte's observations
Per DIPN 61, each asset pool generally would be considered separately when determining whether each pool should constitute a "fund".

Example 4(2): Different classes of interest



Key feature
- No segregation of assets and liabilities between classes of interest.

Deloitte's observations
The IRD indicates that in order to reduce the administrative burden placed on the operator, it is prepared to **treat the different classes of interest as if they are a single fund** in certain situations (e.g., the units of each different class issued in series are identical in all respects, and the income of all share classes of the fund will derive from a single pool of assets in current and future reporting periods).

Tax exemption for special purpose entity (SPE) owned by a fund

Under the unified regime, the tax exemption also applies to a qualifying SPE owned by a tax-exempt fund, in respect of the SPE's profits from its transactions in an investee private company or an interposed SPE, provided the relevant conditions are satisfied. The amount of the exemption is determined by the percentage of the tax-exempt fund's ownership of the SPE.

Investments of SPE

The definition of an SPE under the unified regime, apart from other conditions, refers to an entity that is established solely for the purpose of holding and administering one or more investee private companies. As such, it would appear that by definition, a SPE may not hold investments other than in private companies if it is to qualify for the tax exemption. However, the IRD clarifies in DIPN 61 that it will continue to accept that an SPE remains an SPE, provided the SPE does not commence to carry on any trade or activities other than the holding of investments in investee private companies (including listed securities converted from the SPE's previous interests in an investee private company after an initial public offering (IPO)). The IRD does not provide any direct clarification on the opposite situation, i.e., where a listed company after privatization is being sold by an SPE as an investee private company.

Permitted activities of SPE

According to DIPN 61, an SPE's activities in relation to an investee private company that it holds or administers must be restricted to the review of the company's financial statements, attendance at shareholders' meetings, the opening of bank accounts for the collection of dividends or investment receipts, and the appointment of a company secretary and auditor. The IRD also comments that an SPE should not engage in an active business with trading transactions, the provision of services in return for service fees, or manage and administer the business of investee private companies.

Tax residence of SPE

DIPN 61 states that although an SPE may be incorporated, registered, or appointed in Hong Kong, the place of residence of an SPE owned by a private equity fund generally follows that of the fund. This indicates that the IRD may generalize the relationship between a fund and an SPE, and where a Hong Kong SPE is owned by an offshore fund centrally managed and controlled outside Hong Kong, the IRD may not readily accept that the SPE's place of residence is Hong Kong.

According to DIPN 61, in deciding whether a certificate of resident status (COR) could be issued to an SPE, the IRD will examine all the facts and circumstances to determine whether the SPE has substantial business activities in Hong Kong (e.g., whether the SPE has a permanent office or employs staff in Hong Kong to hold and administer its investment in investee private companies). However, DIPN 61 provides no further guidance in this respect.

Deloitte's observations

The IRD's interpretation of the application of the tax exemption to SPEs in DIPN 61 does not differ significantly from its previous practice. In particular, the investments and activities that an SPE is permitted to make and conduct remain restrictive. We hope that the IRD will consider relaxing its interpretation in this respect. For example, to allow more flexibility, the market would welcome the IRD taking a more liberal approach by allowing a tax exemption to SPEs with respect to transactions in other "qualifying assets"[1]. Otherwise, this essentially would limit the availability of the tax exemption to an SPE in a strict and purely private equity fund context. For instance, if an SPE holds both securities that always have been listed and shares in private companies, it may not satisfy the definition of an SPE for the purpose of the tax exemption. Meanwhile, for the avoidance of doubt, the IRD also should provide direct clarification that, mirroring the example cited in DIPN 61 regarding an SPE's sale of post-IPO securities, in the opposite situation where an SPE sells privatized shares that previously were listed, the SPE equally should be tax-exempt.

On the other hand, the example cited by the IRD in DIPN 61 concerning the residence of SPEs is too generic. The IRD does not provide any guidance on whether, and if so, to what extent, the IRD would assess the substantial level of business activities with reference to the limited activities that an SPE may undertake. The IRD mentions that whether an SPE has a permanent office or staff in Hong Kong should be considered when determining whether the SPE has substantial business activities in Hong Kong. However, the IRD does not appear to acknowledge that an SPE (which merely is holding and administering investee private companies) normally would not have any permanent office or staff. In this regard, we would propose that the IRD adopt a holistic approach to its assessment of business substance when considering an SPE's COR application. In particular, we would welcome clarification from the IRD that they will consider the business substance of the overall fund platform, and that an SPE may leverage the business substance of the fund, general partner, and/or fund manager in its COR application. This is very important to the competitiveness of Hong Kong's tax regime for funds, particularly against the backdrop of the introduction of limited partnership regime for funds in Hong Kong, intended to attract more industry players to establish or redomicile their

[1] "Qualifying assets" mean classes of assets specified in Section 16C of the Hong Kong's Inland Revenue Ordinance for transactions qualifying for the tax exemption under the unified regime.

funds or fund managers in Hong Kong. The Limited Partnership Fund Bill was passed by the Legislative Council on 9 July 2020. For further details, please refer to the Deloitte's commentary.

Qualifying transactions

Under the unified regime, a fund's transactions in "qualifying assets" (qualifying transactions) would qualify for the tax exemption where the relevant conditions are satisfied. The IRD sets out the key definitions and interpretations of qualifying assets in Appendix 2 of DIPN 61.

Apart from the unified regime, Hong Kong has a similar tax exemption regime for nonresident funds in respect of their profits from "specified transactions" (nonresident regime). The IRD issued DIPN No. 43 (Revised) (DIPN 43) providing guidance on the nonresident regime, which also sets out the IRD's views on whether particular transactions qualify as specified transactions.

Although the lists of specified transactions in DIPN 43 and qualifying assets in DIPN 61 are essentially similar, there are some key differences, as highlighted in the table below.

DIPN 43	DIPN 61	Deloitte's observations
A transaction in nonperforming loans is a specified transaction as a "transaction in securities" for the purpose of the nonresident regime.	A transaction in loans or distressed debts structured **in the form of securities** is a qualifying transaction for the purpose of the unified regime, but DIPN 61 is silent on whether a transaction in loans or distressed debts <u>not</u> structured in the form of securities constitutes a qualifying transaction.	It appears that transactions in loans or distressed debts that are <u>not</u> structured in the form of securities may not qualify for the tax exemption under the unified regime.
The placing of funds **by way of investment** is covered by a "transaction consisting in the making of a deposit other than by way of a money-lending business," and hence is a specified transaction for the purpose of the nonresident regime.	A "deposit other than by way of a money-lending business" should not cover a "loan," **whether made out or acquired as an investment**.	According to the Report of the Bills Committee on the Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005 (the bill extending the nonresident regime to private equity funds), "making of deposits other than by way of a money-lending business covers **money deposits** …" In this regard, it is unclear whether the IRD has changed its position by clarifying that a loan, whether made out or acquired as an investment, is not covered by "deposit other than by way of a money-lending business", or is merely clarifying that "placing of funds" always has been intended to apply only to money deposits. In this regard, it appears that the IRD would not consider loans to be covered by a transaction consisting in the making of a deposit other than by way of a money-lending business, and hence, for a transaction in loans to qualify for tax exemption under the unified regime, it must qualify as a "transaction in securities" (i.e., be structured **in the form of securities,** see above).

Unresolved areas

We welcome this long-awaited issuance of practice notes by the IRD, which undoubtedly provides further clarity on the implementation of the unified regime. However, certain issues and concerns remain unresolved, or are not adequately addressed in DIPN 61, as follows:

<u>Receipt of interest being "incidental transactions"</u>

Under the unified regime, provided the relevant conditions are satisfied, income from incidental transactions would be exempt only where it does not exceed 5% of the total trading receipts from qualifying transactions and incidental transactions. Where the 5% threshold is exceeded, the tax exemption will not apply to income from incidental transactions and the income generally will be taxable in Hong Kong if it is sourced in Hong Kong and revenue in nature.

Deloitte's observations

In DIPN 61, the IRD's point of view remains that custody of securities, and receipt of interest or dividends on securities acquired through qualifying transactions are merely incidental transactions, which means they are subject to the 5% threshold. We would like to see the IRD also regard interest income from the holding of debt securities as income from qualifying transactions so that the unified regime would be equally attractive to typical fixed income, bond, and credit funds.

Benchmark figures for "bona fide widely held" exception to deeming provisions

In order to prevent abuse or round-tripping, the unified regime contains anti-avoidance provisions (deeming provisions) which, where triggered, attribute income to certain Hong Kong resident investors who hold a beneficial interest in a tax-exempt fund according to their percentage holdings. The deeming provisions do not apply where the fund is "bona fide widely held." The IRD clarifies in DIPN 61 that in interpreting bona fide widely held for the purpose of the unified regime, it will continue to adopt the existing benchmark figures,[2] which are relatively high and very difficult for a typical private equity/venture capital fund to meet.

Deloitte's observations

Despite the concerns of the private equity fund industry regarding the benchmark figures, the IRD reiterates in DIPN 61 that the bona fide widely held test applies to all funds, even though private equity funds by their nature are unlikely to be widely held, without indicating any relaxation of the numerical threshold to accommodate the specific circumstances such funds. We suggest that the IRD introduce a new, separate, and more relaxed set of thresholds tailored to the private equity industry. Otherwise, private equity/venture capital funds that typically are structured as closely held vehicles with a small number of investors, may be unfairly disadvantaged under the unified regime.

Taxation of carried interest

The IRD states in DIPN 61 that its current practice relating to the taxation of investment managers remains unchanged and it will continue to follow DIPN 51 in the application of anti-abuse provisions to the taxation of investment managers.

In DIPN 51, the IRD for the first time clearly stated its positon that carried interest could be considered to be in the nature of a service fee/employment income, and that the IRD may apply the general anti-avoidance provisions to tax carried interest if the carried interest is disguised as an investment return, unless the return is an arm's length return on a genuine investment. Carried interest, even in the form of partnership distributions from the fund/carry vehicle, also may be caught by the general anti-avoidance provisions, and recharacterized by the IRD as service fee/employment income potentially subject to Hong Kong tax.

Carried interest has long been a contentious issue in Hong Kong. Unlike some other jurisdictions where there are clear rules on the tax treatment of carried interest that allow certain tax concessions, Hong Kong’s Inland Revenue Ordinance contains no specific provisions governing the tax treatment of carried interest.

Deloitte's observations

Although the current DIPN 61 does not help to clarify the tax treatment of carried interest, Hong Kong Financial Secretary Paul Chan announced in his 2020-21 Budget speech on 26 February 2020 that Hong Kong plans to provide a tax concession for carried interest issued by private equity funds operating in Hong Kong where certain conditions are met. Further details are awaited but based on our understanding of the industry's sentiment and market expectations, we would suggest that the government design the tax concession in the form of a blanket tax exemption for carried interest (subject to certain conditions).

Way forward

We welcome the various initiatives launched by the government in recent years to help promote Hong Kong's fund industry. The coming into effect of the unified regime, together with the additional clarification provided by the issuance of DIPN 61 mean that a Hong Kong tax exemption is available for funds in Hong Kong where certain conditions are met. The proposed introduction of a tax concession for carried interest for funds operating in Hong Kong also has been well received by the industry. If Hong Kong stipulates a tax exemption mechanism for carried interest, this should be a significant factor in attracting more funds to Hong Kong.

Hong Kong is moving in the right direction. The attractiveness of the overall tax environment for funds in Hong Kong would be further enhanced by the IRD’s confirmation that it also would consider the business substance of the whole fund (including the activities undertaken by the fund manager or adviser via a regional investment platform) in Hong Kong in determining whether

[2] "During the year of assessment in question, at no time did fewer than 50 persons hold (or have the right to become the holders of) all of the units, shares or interests in the fund; and (b) at no time during the year did fewer than 21 persons hold (or have the right to become the holders of) units or shares that entitled the holders, directly or indirectly, to 75%, or more, of the income or property of the fund."

to issue a COR to an SPE. The Hong Kong tax system, together with the enhanced legal framework resulting from the introduction of the limited partnership regime for funds, then would provide valuable support to Hong Kong's fund industry and significantly enhance Hong Kong's competitiveness as a global asset management hub.

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