

## *Bill to change Hong Kong's profits tax exemption for funds gazetted*

*Hong Kong: December 2018*

### **In Brief**

On 12 December 2018, the Bill to amend Hong Kong's profits tax exemption for privately offered funds was introduced to the Legislative Council for its first and second reading, following its gazettal on 7 December 2018. The Bill is largely consistent with the Financial Services and the Treasury Bureau (FSTB)'s proposals summarised [here](#). It clarifies some initial uncertainties, including the impact of the changes to non-fund entities (their tax treatment will remain unchanged and the previously applicable profits tax exemption regime will continue to operate separately), and Hong Kong privately offered open-ended fund companies (OFCs).

This Bill unifies the profits tax exemptions for privately offered funds (onshore or offshore, regardless of their structure, location of central management and control, their size, or the purpose they serve) into one comprehensive regime. It also widens the application scope of the profits tax exemption significantly, putting Hong Kong in a much more competitive position as a regional and international asset and fund management centre.

Read on to learn more about the key changes and how they may impact your business.

### *In detail*

The Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018 (the Bill) introduces changes to the existing profits tax exemption for privately offered funds, mainly to:

- allow the profits tax exemption to apply whether or not the central management and control of the fund is exercised in Hong Kong;
- allow the profits tax exemption to apply to a fund's investments in Hong Kong and non-Hong Kong private companies; and
- remove the "tainting" effect whereby a profits tax exemption would still be available for the "good" transactions of the fund, even if the fund carries out "bad" transactions.

The Bill, when enacted, will come into operation on 1 April 2019.

To bring about the above changes, there will be two sets of distinct profits tax exemptions, which will operate in parallel:

- **Relating to non-funds** – the current profits tax exemption and its conditions, will continue to apply to non-funds – these remain unchanged (currently Sections 20AC and 20ACA of the Inland Revenue Ordinance).
- **Relating to funds** – the Bill introduces new provisions for funds, these include:
  - a definition of "**fund**". The meaning of fund is largely similar to that of "collective investment scheme" under the Securities and Futures Ordinance. A sovereign wealth fund falls within the definition of a fund. (Section 20AM of the Bill).
  - a profits tax exemption to such funds (i.e. those falling within the definition), **and special purpose entities** (SPEs) of such funds. A SPE is a legal entity that is wholly or partly owned by a fund. If the fund is tax exempt (under the new provisions), the SPE is also exempt to the extent that corresponds to the

percentage of shares / interests that the fund holds in the entity. (Sections 20AN and 20AO of the Bill).

- anti-avoidance measures, being the inclusion of specific requirements the fund and SPEs have to meet relating to their investments in private companies, being (i) **the immovable property test**, (ii) **the holding period test**, and (iii) **the short-term assets test**. (Sections 20AP and 20AQ of the Bill).
- the new provisions relating to funds will also apply to privately offered OFCs. The existing conditions an OFC had to fulfil for the profits tax exemption to apply, such as the “non-closely held” condition, will be repealed.

### *The new conditions relating to funds*

Below is a high-level summary of the new conditions a fund has to fulfil to make use of the new profits tax exemption regime. The following should be read with care, as many of the terms used are specifically defined under the Bill (such as the ones in bold).

Firstly, the arrangement has to fall within the lengthy definition of “fund”.

If the arrangement is a fund, the **qualifying transactions** and **incidental transactions** of a fund will be exempt from Hong Kong profits tax, provided the below conditions are met:

- the qualifying transactions of the fund are carried out in Hong Kong by or through a **specified person**; or arranged in Hong Kong by a **specified person**; or
- the fund is a **qualified investment fund**; and
- the income arising from transactions incidental to the carrying out of qualifying transactions does not exceed 5% of the fund’s total trading receipts.

The Bill also exempts SPEs from paying profits tax on their assessable profits in relation to certain transactions. These are limited to transactions in private companies only.

As mentioned, there are anti-avoidance measures. Sections 20AP and 20AQ of the Bill set out some requirements on investments in private companies a fund has to fulfil for it to enjoy the profits tax exemption. These are as follows:

- **Immovable property test** – the fund holds (directly or indirectly) not more than 10% of the value of its assets in immovable property (excluding **infrastructure**) in Hong Kong; and
- **Holding period test** – the fund has held the private company for at least two years.

Failing the holding period test, a third test would apply:

- **Short-term assets test** – the fund does not have a controlling stake in the private company; or if the fund has a controlling stake in the private company, the latter does not hold more than 50% of the value of its assets in short-term assets (being those assets held for less than 3 consecutive years before the date of disposal).

### *The takeaway*

The Bill brings a fundamental change to how the profits tax exemption for privately offered funds is applied in practice, and while there are slight intricacies to be mindful of, we are pleased to see that the various current profits tax exemptions for privately offered funds are now unified into one comprehensive regime. The following positive changes are worth noting:

- A fund can be centrally managed and controlled in Hong Kong or outside Hong Kong.
- There is no “tainting” such that funds will enjoy a profits tax exemption on their “good” transactions even if the fund carries out “bad” transactions.
- A fund can also invest in Hong Kong companies and businesses.
- The exclusion of infrastructure from the definition of “immovable property” is a positive change as it widens the type of assets a fund can invest in, while still making use of the profits tax exemption. This paves way for infrastructure funds and fund management to thrive in Hong Kong.
- The funds and the newly defined SPEs are exempt from profits tax in relation to transactions in private companies, subject to other conditions being met. This seems to mean that SPEs are not bound by the new classes of assets specific for transactions as set out in the new Schedule 16C. If this is the case, can funds make investments that are co-invested by the Innovation and Technology Venture Fund Corporation (ITVFC) indirectly through SPEs (i.e. instead of a direct investment)?

These changes would help grow and develop the asset and wealth management industry in Hong Kong as a whole. With the flexibility to have Hong Kong company directors and hold board meetings in Hong Kong, we expect the changes to attract talent to Hong Kong and retain talent as well, echoing the sentiment in the Hong Kong Chief Executive's 2018 Policy Address.

### *Other points to note*

We also have a few observations for consideration. We noted that pension funds are not explicitly included in the definition of a fund. Could pension funds enjoy the proposed unified profits tax exemption? What about a "fund of one"? Also, "employee investment fund vehicles" are excluded from the definition of a fund. We hope to see clarification on these issues before the Bill is enacted.

The speed at which these changes have come into place is indicative of the Hong Kong SAR Government's commitment to ensure Hong Kong retains its competitiveness as a regional and global asset and fund management centre. It has been less than a year since the concerns over the ring-fencing features in the profits tax exemption regime came to light, and the Hong Kong legislature has reacted quickly to address these issues, going through an industry consultation process, to the Bill's gazettal.

The Bill was introduced into the Legislative Council for its second reading on 12 December 2018. We expect a Bills Committee to be formed to review the Bill before it will be enacted into law. Market players should assess the potential impact of the changes to their businesses and operations. We will closely monitor the further developments.

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