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HONG KONG TAX ALERT

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Hong Kong to implement Open-ended Fund Companies ("OFC") regime in July 2018

Summary

The OFC regime is targeted to come into effect from 30 July 2018. The OFC regime will provide fund managers with the option of setting up a fund in the form of a Hong Kong company.

While this is another potentially welcome tax incentive that could promote Hong Kong as a potential fund domiciliation location, the potentially onerous conditions that need to be satisfied in order to qualify for the tax exemption may limit its practical application.

On 18 May 2018, the government gazetted the Securities and Futures (Open-ended Fund Companies) Rules and the Securities and Futures (Open-ended Fund Companies)(Fees) Regulations, both subsidiary legislation under the Securities and Futures Ordinance. The OFC regime is targeted to come into effect on 30 July 2018.

To complement the new OFC regime, the Inland Revenue (Amendment) (No. 2) Ordinance 2018 ("the Ordinance") (click here) will extend a profits tax exemption to Hong Kong resident *privately* offered OFCs. This tax exemption will also take effect on 30 July 2018. If the OFC is *publicly* offered, another tax exemption will likely apply to it.

The OFC regime will provide fund managers with the option of setting up a mutual fund in the form of a Hong Kong company, in addition to forming a unit trust. This will help diversify Hong Kong's fund domiciliation platform and hopefully bolster Hong Kong's asset management industry.

OFC framework and requirements

Broadly, an OFC is an open-ended collective investment scheme that is intended to operate as an investment fund vehicle managed by a professional investment manager. The OFC is set up in the form of a limited liability company but with the flexibility to create and cancel shares for investors' subscriptions and redemptions (which is not currently possible in the case of conventional companies).

OFCs will not be bound by the prohibitions on distributions out of share capital that apply to conventional companies, and instead may distribute out of share capital subject to solvency and disclosure requirements.

The key qualifying conditions for a privately offered OFC to enjoy the profits tax exemption are as follows:

- The OFC must be a Hong Kong resident, i.e., its central management and control must be exercised in Hong Kong.
- The OFC must not be closely held.
- The OFC must carry out "qualifying transactions". These are transactions in asset classes specified in Schedule 16A. Generally, these assets comprise securities; shares of, or debentures issued by, a private company; futures contracts; foreign exchange contracts under which the parties to the contract agree to exchange different currencies on a particular date; deposits made with a bank; foreign currencies; certificates of deposits; cash; and OTC derivative products. In addition, the OFC can carry out transactions incidental to the carrying out of qualifying transactions provided that its trading receipts from such incidental transactions do not exceed 5% of the OFC's trading receipts from both its qualifying and incidental transactions.
- Such transactions must be carried out through or arranged by a "qualified person" in Hong Kong. This term refers to a corporation licensed under Part V of the Securities and Futures Ordinance to carry on Type 9 (asset management) regulated activity.

Gains from transactions in assets that are not listed in Schedule 16A also qualify for tax exemption if such transactions are carried out or arranged by a qualified person in Hong Kong. However, under the SFC regulation, non-Schedule 16A assets cannot comprise more than 10% of an OFC's total assets. If the OFC exceeds this 10% threshold during the relevant year, the OFC will not qualify for any tax exemption at all.

That said, the profits derived by an OFC from the following transactions will not be tax exempt in Hong Kong:

i. Transactions in shares of, or debentures issued by, a private company (whether incorporated in Hong Kong or elsewhere), where the private company directly or indirectly holds real estate in Hong Kong or shares in private companies that hold real estate in Hong Kong, and the aggregate value of the holding in such real estate and shares exceeds 10% of the value of the private company's total assets.

ii. Transactions in shares of, or debentures issued by, a private company (whether incorporated in Hong Kong or elsewhere), over which the OFC has control and which holds "short term assets", if the aggregate value of the short term assets exceeds 50% of the value of the total assets of the private company. A short term asset is defined as an asset that is not within Schedule 16A, is not real estate in Hong Kong, and has been held by the private company for less than 3 consecutive years prior to the disposal of the private company by the OFC.

iii. Transactions in respect of assets not within Schedule 16A held pursuant to a direct trading or business undertaking in Hong Kong, or where such assets are being used to generate income.

These restrictions will create an administrative burden for OFCs in monitoring their compliance at all times with the conditions for tax exemption.

There are also complex conditions and thresholds in meeting the "non-closely held" definition including the number of investors, the minimum investment amount and the participation interest of each investor. The OFC also has other

strict requirements to meet such as registering with the SFC, having an investment manager licensed for the Type 9 (asset management) regulated activity, appointing a custodian to safe keep assets, maintaining a registered office in Hong Kong, and having at least two individual directors.

Removing the "ring-fencing" effect of the original bill

In the original bill issued in July 2017, transactions in foreign incorporated private companies were considered to be qualifying transactions, but transactions in Hong Kong incorporated private companies were not. This restriction was viewed as "ring-fencing". Such a feature is now generally unacceptable to the OECD and the EU in evaluating whether a jurisdiction is engaging in harmful tax practices.

The new ordinance removes the "ring-fencing" effect of the original bill by extending the scope for tax exemption to include dealings in shares in Hong Kong incorporated companies, subject to meeting certain conditions.

Key tax limitations

While this is a welcome incentive, its application may be limited. The key limitations are as follows:

- The ordinance is silent on the stamp duty implications associated with an OFC. Currently under Hong Kong stamp duty law, the allotment and cancellation of Hong Kong stocks (e.g., shares in an OFC) are not subject to stamp duty. However, the transfer of shares of an OFC would be subject to stamp duty. In order for the OFC regime to be workable, there should be a blanket exemption from stamp duty for transfers of shares in OFCs.
- The OFC must continue to meet the non-closely held test for 24 months after the first (up to) 24-months' grace period from foundation. If not, the OFC will be taxable retrospectively from its start-up date.
- The OFC can seek an exemption from the Commissioner of Inland Revenue from meeting the "non-closely held" condition. However, there is no objective test for the Commissioner to exercise his discretion.
- For carried interest distributions, there is a provision that deems dividends from a non-exempt OFC to be taxable to the extent they are in relation to services rendered in Hong Kong. This does not take into account a carry distribution in connection with an investment in the OFC.

It should also be noted that, if a Hong Kong resident (together with its associates) owns 30%+ of the issued share capital of the OFC (or of a sub-fund of the OFC), that resident will be taxed on its pro-rata interest of the exempted profits of the OFC (or the sub-fund). The same applies if a Hong Kong resident is an associate of the OFC (or of a sub-fund) holding less than a 30% interest.

KPMG observations

The Hong Kong government recognizes that the asset management industry is a fast growing sector within the financial services industry. While this is another potentially welcome tax incentive that could promote Hong Kong as a potential fund domiciliation location, the potentially onerous conditions that need to be satisfied in order to qualify for the tax exemption may limit its practical application.

For the OFC regime to be widely used in the funds industry, further enhancements are required to make the regime more business friendly.

For further details on the Profits Tax exemption for privately offered open-ended fund companies, please see our previous Hong Kong Tax Alert 2017 – Issue 14, July 2017. For more information and assistance, please contact your usual tax advisor or one of our tax advisors below.

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