Executive summary

On 29 March 2018, Hong Kong’s “Inland Revenue (Amendment) (No. 4) Bill 2017” (the Bill)1 to extend the profits tax exemption for open-ended fund companies (OFCs) became law (the New Law), after being passed by the Legislative Council on 21 March 2018. The New Law removes the ring-fencing effect of the Bill and addresses identified potential tax loopholes.

Detailed discussion

Overview

The New Law provides that an OFC will be exempt from tax in Hong Kong on certain specified types of income if all the following conditions are satisfied:

- The OFC is a Hong Kong resident corporation with its central management and control exercised in Hong Kong.
- The OFC is non-closely held.
- The relevant transactions must be carried out in Hong Kong by or through a qualified person, or arranged in Hong Kong by a qualified person.2
The profits derived by an OFC from transactions in assets and incidental transactions will be exempt from tax in Hong Kong, except for the following:

- Transactions in shares of, or debentures issued by, a Hong Kong or overseas incorporated private company which holds Hong Kong immovable property or certain level of other short-term assets.

- Transactions involving the OFC carrying on direct trading or business in Hong Kong in non-permissible asset classes; or holding assets in non-permissible asset classes which are used for generating income.

No explicit tainting provision is included

Contrary to the Bill, the New Law does not include any explicit tainting provision regarding the non-qualifying transactions. However, the Government has noted that the code governing the operations of OFCs to be set out by the Securities and Futures Commission will include conditions prohibiting an OFC from making an investment in non-qualifying transactions which exceeds 10% of its total investment. Once the registration license of an OFC is revoked, it would no longer be eligible for the tax exemption under the New Law.

Perceived “ring-fencing” effect of the Bill is removed

To avoid being regarded as an unacceptable harmful tax practice under the Organisation for Economic Co-operation and Development’s Base Erosion and Profit Shifting (BEPS) initiative, the New Law removes the perceived ring-fencing effect of the Bill by extending the scope for tax exemptions to include Hong Kong incorporated private companies, in addition to transactions in overseas private companies.

As a means of addressing potential tax loopholes by making use of an overseas incorporated private company to acquire Hong Kong immovable property or other short-term assets followed by the sale of the overseas incorporated private company as a means of dealing in the underlying assets, transactions in Hong Kong and overseas incorporated private companies are now subject to the same exceptions discussed above. This safeguard against tax abuse applies equally to transactions involving the use of Hong Kong incorporated private companies as previously stated, and to those transactions in non-permissible assets directly undertaken by an OFC.

Endnotes

1. See EY Global Tax Alert, Hong Kong proposes profits tax exemption for resident privately-offered open-ended fund companies, dated 12 July 2017.

2. A qualified person is a corporation licensed or registered for carrying on specified regulated activity under the Securities and Futures Ordinance.

3. The permissible asset classes are securities, futures contracts, certificates of deposit, over-the-counter derivative products, certain foreign exchange contracts, specified deposits, foreign currencies and cash.
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