18 December 2018

Global Tax Alert

Hong Kong proposes to remove ring-fencing features of current exemption regime for privately-offered funds

NEW! EY Tax News Update: Global Edition

EY's new Tax News Update: Global Edition is a free, personalized email subscription service that allows you to receive EY Global Tax Alerts, newsletters, events, and thought leadership published across all areas of tax. Access more information about the tool and registration here.

Also available is our EY Global Tax Alert Library on ey.com.

Executive summary

Under the current tax regime, Hong Kong's profits tax exemption[1] is only offered to non-Hong Kong resident privately-offered funds. However, to fully qualify for the profits tax exemption, non-Hong Kong resident funds are prohibited from investing in private companies incorporated in Hong Kong.

The exclusion of resident privately-offered funds and the prohibition on investing in local private companies were identified as a harmful tax practice by the European Union (EU) because of ring-fencing.

To address the ring-fencing concerns, the Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018 (the Bill) was issued on 7 December 2018 to introduce a unified exemption regime for all funds.

This Alert summarizes the key provisions of the Bill.

Detailed discussion

Removing ring-fencing features

The Bill proposes that *regardless of the residence, size and type*, where an entity: (i) qualifies as a "fund" as defined; and (ii) has engaged a "specified person"[2] to arrange or carry out its transactions or has a "qualifying fund" status,[3] the entity will be exempt from Hong Kong's profits tax on certain transactions.

Building a better working world

Under the Bill, a fund or a special purpose entity (SPE) will not be taxed on its profits arising from the transaction in a private company, *irrespective of the country of its incorporation*, if the following tests are met:

- **Immovable property test**: the fund or SPE does not invest in a private company that holds directly or indirectly more than 10% of its assets in immovable property[4] in Hong Kong and shares in other private companies with direct or indirect holding of immovable property in Hong Kong.

Once the above immovable property test is satisfied, the fund or SPE must also satisfy one of the following two tests:

- **Holding period test**: the investment in the private company has been held by the fund or SPE for at least two years, whether or not the fund or SPE has control over the private company.
- **Short-term assets test**: (i) the fund or SPE does not have a controlling interest in the private company; or (ii) the fund or SPE has a controlling interest in the private company, but the latter does not hold (directly or indirectly) short-term asset value in the aggregate exceeding 50% of the value of the total assets of the private company.

Removing tainting features

Under the existing exemption regime, a single non-specified transaction would cause income derived from specified transactions of a nonresident person to be taxable in Hong Kong when such income would otherwise be exempt (the "tainting" provision).

The proposed unified exemption regime does not include the "tainting" provision; accordingly, the tax-exempt profits of a fund or a SPE will not be tainted by disqualifying transactions.

No change to non-fund entities' qualification to tax exempt status

Under the proposed exemption regime, only the entity qualifying as a "fund" could be exempt from tax whereas under the current exemption regime, nonresident persons that satisfy the exemption conditions would be eligible for tax exemption, regardless of whether they are established as "funds."

To avoid impacting those non-fund entities, the Bill proposes to retain the current tax exemption regime for the non-fund entities.

Endnotes

1. Except those established as Hong Kong resident open-ended fund companies to which a separate profits tax exemption scheme may apply.
2. "Specified persons" generally refer to persons licensed by the Securities and Futures Commission.
3. A fund would be regarded as a "qualified investment fund" if, not including the originator and its associates, it has more than four investors and these investors contribute more than 90% of the capital of the fund. Furthermore, the distribution of the net proceeds of the fund to the originator and its associates cannot exceed 30%.
4. The term immovable property excludes infrastructure.

For additional information with respect to this Alert, please contact the following:

Ernst & Young Tax Services Limited, Hong Kong

- Tracy Ho tracy.ho@hk.ey.com
- Florence Chan, *Financial Services* florence.chan@hk.ey.com

Ernst & Young LLP, Hong Kong Tax Desk, New York

- Rex Lo rex.lo1@ey.com

Ernst & Young LLP, Asia Pacific Business Group, New York

- Chris Finnerty chris.finnerty1@ey.com
- Kaz Parsch kazuyo.parsch@ey.com
- Bee-Khun Yap bee-khun.yap@ey.com

EY | Assurance | Tax | Transactions | Advisory

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

EYG no. 012440-18Gbl

1508-1600216 NY
ED None

ey.com