DIPN 61 – the Hong Kong IRD’s views on the profits tax exemption for funds

10 July 2020

In brief
The Hong Kong Inland Revenue Department (IRD) published the long-awaited Departmental Interpretation and Practice Notes No. 61 (DIPN 61) on the profits tax exemption for privately offered funds on 30 June 2020. At 105 pages, DIPN 61 is a comprehensive document, and provides market players with an insight into the IRD’s views on the application of the profits tax exemption for privately offered funds. In this newsflash, we highlight some of the key guidelines to take note of.

In detail
Some key guidelines, although not exhaustive, are set out below.

Scope & coverage of DIPN 61
DIPN 61 provides the IRD’s view on The Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Ordinance 2019, which came into force on 1 April 2019. This exemption is commonly referred to as the unified tax exemption for funds (or UTE) and provides a profits tax exemption for privately offered funds operating in Hong Kong, irrespective of where it is domiciled or its form (e.g. it may be a Hong Kong domiciled unit trust, limited partnership, open-ended fund company; a Cayman Islands exempted company or an exempted limited partnership, etc.).

Commencement date
DIPN 61 states that the UTE came into operation on 1 April 2019. For funds with a calendar year end (of 31 December), there will be a three-month period from 1 January 2019 to 31 March 2019 where the fund would not be able to make use of the UTE. For that three-month period, it would have to rely on Section 20AC (commonly referred to as the Non-Fund Investor Exemption) of the Inland Revenue Ordinance to exempt the profits derived if it fulfils the specified conditions. Unlike the UTE, the Non-Fund Investor Exemption includes a “tainting” provision which causes a fund to lose its entire exemption for a year of assessment if it invests in any non-qualifying assets. It is thus important for funds to review their transactions from 1 January 2020 to 31 March 2020 to ascertain whether there is any tax exposure.

Tax residence of fund and Special Purpose Entities
The IRD will issue a certificate of resident status to a fund that is a resident of Hong Kong. The IRD will also issue a certificate of resident status to a special purpose entity (SPE) of a fund if it can be proved that the SPE is resident in Hong Kong, taking into consideration all facts and circumstances. An SPE that is a mere conduit will be refused a certificate of resident status.
Different classes of interest
DIPN 61 provides that “if an asset pool has different classes of interests...each class of interest will be considered separately for the purpose of determining whether that class of interest constitutes a separate fund.” Some hedge funds, private equity and real estate funds were set up with different classes of interest and the investors in each of the classes had different distribution rights, but all in the same pool of assets. The IRD’s view would seem problematic for such funds. However, DIPN 61 goes on to say that the Commissioner is prepared to reduce the administrative burden placed on the operator by treating the different classes of interests as if they are a single fund, provided that there is no segregation of assets and liabilities. This offers more flexibility in application.

Listed and unlisted securities
It is common for private equity funds to invest in a target through an SPE. The definition of SPE does not include investments in listed shares. However, the IRD considers that when an SPE disposes of an investee private company through an IPO, this is in substance no different from a transaction in listed companies or a transaction in securities of an investee private company. Therefore, the fund / SPE will continue to be eligible under the UTE provided the other conditions are met. Likewise, the profits tax exemption would continue to apply to a fund / SPE if it sold an investee private company, which was previously listed but was privatised at the time of sale. This shows that the IRD is prepared to adopt a flexible and broad interpretation of the law when required.

Holding of debt instruments and distressed debts
The IRD continues to take the view that the holding of a debt instrument to derive interest income is not a transaction in securities, and considers the receipt of interest as income from an incidental transaction. This means that an investment in debt instruments does not enjoy the same exemption as that offered to say, an equity investment. This position creates an inherent disadvantage to investment managers wanting to manage unauthorised fixed income and/or credit funds in Hong Kong if the interest income is of Hong Kong source.

Fund-of-one
It is the IRD’s view that ‘an arrangement intended to have one single investor only [i.e. a fund-of-one] is unlikely an arrangement under which the capital contributions and profits or income are pooled and would not satisfy the “pooling” requirement’. This suggests that a fund-of-one may not be regarded by the IRD as a fund for UTE purposes.

Pension Funds
DIPN 61 provides an example where a national pension fund, as a limited partner of a fund, is regarded as a single investor. Although DIPN 61 does not explicitly state that pension funds are investment funds, the Government’s responses to written submissions on the UTE Bill in 2018 indicated that bona fide funds would include pension funds.

The takeaway
Over the past 20 years, Hong Kong has introduced many changes to its tax laws to ensure it remains competitive and attractive to the asset and fund management industry. Overall, the profits tax exemptions have worked well for certain types of funds and represent the significant efforts the government has taken to further develop Hong Kong’s asset management industry. We anticipate the introduction of the limited partnership regime for funds and the proposed carried interest concession, which will enrich Hong Kong’s asset and wealth management ecosystem.

Due to the lack of guidance in the tax law, DIPN 61 provides better clarity to taxpayers on how the IRD would apply the UTE and in doing so, helps manage taxpayers’ expectations to a certain extent. With that being said, DIPNs have no legal binding force and only serves to provide taxpayers with general information on how the IRD applies the tax law in practice. We hope that with this guidance, taxpayers will have more confidence to make use of the UTE and its benefits.

Endnotes
1. Unless the loans or distressed debts are structured in the form of securities, which are assets of a Schedule 16C class.
2. The Limited Partnership Fund Bill was passed by the Legislative Council on 9 July 2020. The Limited Partnership Fund Ordinance will come into operation on 31 August 2020.
3. The Financial Secretary announced in the 2020-21 Budget that the Government plans to provide a tax concession for carried interest issued by private equity funds operating in Hong Kong. Details have yet to be announced.
Let's talk

For a deeper discussion of how this impacts your business, please contact your usual PwC contact or one of us:

PwC's Financial Services Tax Team based in Hong Kong

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