CityLinkers
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HONG KONG UNIFIED FUND EXEMPTION REGIME - DIPN 61

2022 EDITION

INTRODUCTION

On 30 June 2020, the Hong Kong Inland Revenue Department (IRD) published its Departmental Interpretation and Practice Notes No. 61 (DIPN 61) with respect to the Unified Fund Exemption regime

This is a unified regime providing a Hong Kong Profits Tax exemption to privately offered funds operating in Hong Kong, irrespective of whether they are domiciled or managed in Hong Kong or in a foreign jurisdiction. This regime became effective from 1 April 2019 and does not have retrospective effect

Private equity and venture capital funds, pension and sovereign wealth funds, hedge funds, real estate and infrastructure funds can all potentially benefit from this Unified Fund Exemption regime, which allows funds to establish a fund and / or holding platform in Hong Kong, with an opportunity to streamline decision making, fund management and operations and thereby bolstering substance of the fund and / or holding platform which is expected to be required in this post BEPS world

BRIEF OVERVIEW OF THE UNIFIED FUND EXEMPTION REGIME *(FN1)*

1 THE FUND

Shall meet the definition of "fund" under Section 20AM of the Inland Revenue Ordinance

Shall either be a "qualified investment fund", i.e.

1. have at least 5 investors (not including the originator and its associates);
2. these investors shall contribute more than 90% of the aggregate capital commitments of the fund; and
3. the distribution of the net proceeds of the fund to the originator and its associates shall not exceed 30%;

Or if it is not a "qualified investment fund", the transactions shall be carried out by / through or arranged in Hong Kong by a "specified person" (i.e. a SFC licensed corporation or an authorized financial institution)

2 EXEMPTIONAT THE FUND LEVEL

Qualifying transactions as defined in Schedule 16C (including securities, futures contracts, foreign exchange contracts, shares and bonds issued by an overseas / Hong Kong private companies (subject to conditions ***(FN3)***)

3 SPECIAL PURPOSE ENTITY (SPE) AND INTERPOSED (AND SPE EXEMPTION)

Any onshore / offshore entity wholly or partially owned by the "fund" and established solely for the purpose of holding and administering one or more investee private companies

Exempt from tax in respect of profits from transactions in securities issued by investee private company or an interposed SPE ***(FN3)***

4 INVESTEE PRIVATE COMPANY

An onshore / offshore private company that is not allowed to issue any invitations to the public to subscribe for any shares or debentures of the company

Footnotes :

FN 1: *Please refer to our prior Tax Alerts dated 10 December 2018 and 22 February 2019 for additional background on the rules*

FN2: *With respect to the co investor interest, any gains derived by Holdco 2 may be exempt if the co investor meets the definition of a " under the Unified Fund Exemption regime or a "non resident person" under the Offshore Fund Exemption regime A non resident person or entity which does not meet the definition of " under the Unified Fund Exemption regime but can satisfy the exemption conditions under the Offshore Exemption Regime could continue to enjoy the exemption thereunder*

FN 3: *A Fund, a SPE or interposed SPE will be exempt from Hong Kong Profits Tax on their profits arising from transactions in a SPE, an interposed SPE or an IPC respectively if the "immovable property test" and the "holding period test"test"//"control test"test"//"short term assets test" are met Please refer to the previous tax alerts for further details see above*

FREQUENTLY ASKED QUESTIONS

QUESTION 1:

Is it possible to have more than one "fund" in a fund structure? Can an entity owned by a "fund" (e.g., a regional holding platform) be considered as part of the fund arrangement and/or qualify as a "fund" under Section 20AM of the Inland Revenue Ordinance?

Comments from DIPN 61:

(Paragraph 55) Complex and multi vehicle fund structures, including master-feeder structures and parallel funds, may be used in order to accommodate the preferences of fund investors. The totality of facts, including the constitutive documents, the investment mandate and the management agreements, would be examined to decide whether the feeder funds or parallel funds constitute in law and in fact one or more than one fund within the meaning of "fund" in section 20AM(2)

CityLinkers observation:

- It is a welcome and helpful development that the IRD has acknowledged that private funds often comprise several fund vehicles for commercial and legal reasons. Sub funds, feeder funds, blockers and parallel funds should all be able to qualify as a "fund" either individually, or collectively. Since this will ultimately depend on the facts and circumstances of each fund arrangement and structure, it will be important to contemplate and plan for this at the time of fund set up due to the differing tax treatment of "fund", "SPE" and regular entities under the rules

- While Paragraph 55 does not specifically mention a regional holding platform entity, it may be possible for it to be considered a part of a "fund" in certain circumstances based on the totality of facts (including how the relevant entities are being disclosed in the constitutive and other fund related documents)

QUESTION 2:

Is a Sovereign Wealth Fund or a Pension Fund a "fund"?

Comments from DIPN 61:

(Paragraph 57) The law expressly provides that a sovereign wealth fund is to be regarded as a fund. A sovereign wealth fund is defined under the law to mean an arrangement established and funded by a state or government) for the purposes of (a) carrying out financial activities; and (b) holding and managing a pool of assets, for the benefit of the state or government (or the political subdivision or local authority)

CityLinkers observation:

- Although the IRD has not positively confirmed that a pension fund is a "fund" in DIPN61, it did confirm the same as part of its correspondence on the Bill that introduced the new law; that is, that a pension fund could be considered a "fund" provided that the relevant conditions are met. It will also be important to consider the interaction between Section 26A(1A) (where the pension fund is a publicly offered fund and meets the conditions under this section) and the Unified Fund Exemption, given any arrangement that is exempted from HKPT under Section 26A(1A) is specifically excluded from the definition of "fund" under the Unified Fund Exemption regime

FREQUENTLY ASKED QUESTIONS

QUESTION 3:

If the regional holding platform is not considered to be a "fund", can a regional holding platform be considered as an "SPE" and what are the tax implications?

Comments from DIPN 61:

(Paragraph 105) The exemption available to an SPE will remain applicable to a holding platform entity if the holding platform entity used by a fund as a regional holding platform is a SPE. In other words, the holding platform entity is (a) established solely for the purpose of holding and administering investee private companies; (b) the activities of the holding platform entity are restricted to activities for the purpose in subparagraph (a) above

(Paragraph 105) The holding of assets, other than interests in investee private companies, is
not within the scope of activities permitted under the definition of SPE. Indeed, the assets held by the holding platform entity have to be investee private companies as defined under the law

CityLinkers observation:

- A regional holding platform could be considered as an "SPE", a "fund" (as mentioned in Q1) or a regular taxable entity depending on how it is established and managed. If intended to be an "SPE", it will be important to ensure the activities carried out and assets held by the regional holding platform entity meet the IRD's expectation and interpretation of an "SPE". For example, a regional holding platform entity as an "SPE" cannot enter into other qualifying transactions (e.g., non corporate real estate investment entities) other than securities issued by an investee private company (i.e., not as broad as the transactions that can be carried out by a "fund"). If it does so, it will lose its status as an SPE and not qualify for the exemption

QUESTION 4:

Is fund of one a "fund"?

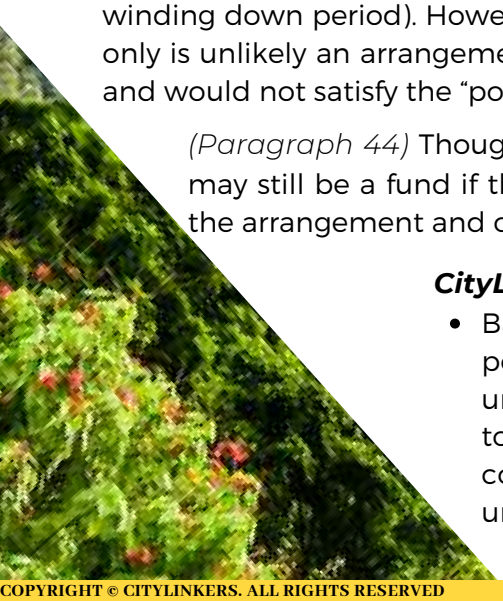
Comments from DIPN 61:

(Paragraph 43) Though certain sections under the law refer to "participating persons", an arrangement under very special circumstances may be accepted or may continue to be accepted as a fund even if it has one investor at a certain point in time within a year of assessment (e.g., during the start up period or winding down period). However, it is apparent that an arrangement intended to have one single investor only is unlikely an arrangement under which the capital contributions and profits or income are pooled and would not satisfy the "pooling" requirement

(Paragraph 44) Though the contributions and profits or income are not pooled, the arrangement may still be a fund if the property is managed as a whole by or on behalf of the person operating the arrangement and other requirements as required in section 20AM(2) are satisfied

CityLinkers observation:

- Based on the IRD's interpretation, a fund of one is unlikely to satisfy the pooling requirement as part of the definition of a "fund" and this creates uncertainties whether a fund of one can qualify as a "fund". Please reach out to us if you are planning to set up a fund of one as it will be important to contemplate and plan for this at the time of fund set up due to this uncertainty



FREQUENTLY ASKED QUESTIONS

QUESTION 5:

For the purposes of the "qualified investment fund" test, how do you count the number of investors in the fund?

Comments from DIPN 61:

(Paragraph 89) An investor like a pension fund, an insurance company or a sovereign wealth fund would be counted as one single investor for the purposes of counting the number of investors and determining whether a fund is a qualified investment fund, even though they have a large number of participating persons and beneficiaries

CityLinkers observation:

- Based on the IRD's interpretation, for example, where a pension fund (with a large number of underlying participating persons) invests in a private equity fund, the pension fund is only regarded as one single investor for the purpose of determining whether that private equity fund meets the "qualified investment fund" test. The same applies where the test fund has other investors that are funds (e.g., other private equity or real estate funds). Accordingly, it will be critical to properly characterize the target fund and its investors for the purposes of determining if the "qualified investment fund" test can be met. For completeness, if the "qualified investment fund" test is not met, you may still rely on the "specified person" test, where applicable, in order to enjoy the exemption

QUESTION 6:

Can credit funds rely on the Unified Fund Exemption regime?

Comments from DIPN 61:

(Paragraph 59) Specifically, a fund is not permitted under the law to engage in the following activities (which are not exhaustive): .... (d) finance, including .... (v) money lending....

(Paragraph 78) The holding of a debt instrument (e.g., debentures, loan stocks, bonds or notes) to earn "interest income" is not a transaction in securities since such holding does not involve two parties transacting in securities. The payment "interest" therefrom is not a "transaction in securities" since the payment of interest to holders of the debt instrument merely gives effect to the rights already attached to the debt instrument

CityLinkers observation:

- The IRD has interpreted the term "transactions" as referring only to the buying and selling of securities and not to the holding of securities to generate passive income. As a consequence, interest earned by a "fund" from the holding of debt securities is not exempt under the Unified Fund Exemption regime, unless it can be regarded as an incidental transaction. "Incidental transactions" may only be exempt to the extent that the fund's trading receipts from the incidental transactions (i.e., the interest income) do not exceed 5% of the fund's total trading receipts from the qualifying transactions and the incidental transactions taken together

FREQUENTLY ASKED QUESTIONS

QUESTION 7:

Can a fund and/or a "SPE" be granted a tax residency certificate (TRC) from the IRD?

Comments from DIPN 61:

(Paragraph 177) If a fund is a resident of Hong Kong for the purposes of a specific double taxation agreement, then a certificate of resident status will be issued to the fund upon application

(Paragraph 183) The certificate of resident status would only be issued to a SPE as a proof of its resident status for claiming tax benefits under the relevant double taxation agreement or arrangement if it can be proved that the SPE is resident in Hong Kong...

CityLinkers observation:

- A TRC should be issued to a fund upon application if the fund is a resident of Hong Kong (e.g., central management and control exercised by the general partner of a partnership fund in Hong Kong)
- It is helpful that the IRD has indicated that an SPE may still be issued a TRC despite the IRD's current restricted interpretation of activities that can be carried out by an SPE, in particular when there are increased substance requirements for treaty relief purpose in this post BEPS world. All the facts and circumstances would need to be examined to determine whether the SPE has substantial business activities in Hong Kong (e.g., whether the SPE has a permanent office or employs staff in Hong Kong to hold and administer its investment in IPCs). In certain circumstances, it may be possible to include the activities of the fund and / or manager towards the business substance of the SPE. That said, where the SPE is a mere conduit, the IRD advised that a TRC would not be granted
- For completeness, it will be very important to carefully consider the activities to be undertaken by a holding company if it is to be respected as the beneficial owner of income for treaty claim purposes yet still meet the definition of an SPE in order to enjoy the exemption

QUESTION 8:

Are take private or Initial Public Offering (IPO) transactions exempted under the Unified Fund Exemption regime?

Comments from DIPN 61:

(Paragraph 126) Depending on the market conditions, a fund may sell its investment in an investee private company to another strategic investor or to the public through an IPO. If a fund sells its investment in the investee private company through an IPO, it is in substance no different from a transaction in listed securities or a transaction in securities of an investee private company. That is, the fund will continue to be eligible for profits tax exemption in respect of the divestment if the exemption conditions under the law remain satisfied. Conversely, if a listed company after privatization is sold as an investee private company, the fund will continue to be exempt from profits tax provided the same exemption conditions have been fulfilled. The extent of exemption for a SPE is the percentage of the tax exempted fund's ownership of the SPE in the year of assessment...

CityLinkers observation:

- While it would be preferred that the exemption available at the SPE level is the same as the exemption available at the fund level, it is helpful that the IRD acknowledged that these two types of transactions (i.e., take private and IPO transactions) undertaken by a fund or an SPE may be exempt under certain circumstances (as opposed to being undertaken by a "fund")

ABOUT CITYLINKERS

CityLinkers Group ("we" or "CityLinkers"), is a group of companies, specialized in providing services of all aspects, including accounting, auditing, tax, company secretarial, compliance, fund raising, corporate finance, financial advisory, internal control, listing consultancy, risk management and trust administration.

Established in 2011, CityLinkers has assisted over 3,000 companies located in Hong Kong, China and other countries to date.

Our team comprises of former executives of multinational companies and listed companies, certified public accountants, chartered tax accountants, appraisers and financial analysts. CityLinkers have teams with a total of over 100 members in Hong Kong and established branch offices established in strategic locations such as Shanghai, Shenzhen, Hangzhou and Singapore.

With our member firms registered under the Hong Kong Institute of Certified Public Accountants ("HKICPA") and the Institute of Singapore Chartered Accountants ("ISCA"), we are able to provide auditing services in both locations. We are also accredited by the HKICPA to provide professional training to their members.

We have also established long term cooperation with other professional parties such as lawyers in Hong Kong and the PRC, sponsors and appraisers, in order to offer a comprehensive range of services to our clients in the areas of listing advisory, due diligence, restructuring and corporate finance.

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10th ANNIVERSARY

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