THE POWER OF BEING UNDERSTOOD

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Welcome to Tax Flash – RSM Tax Advisory (Hong Kong) Limited's Newsletter Covering Technical Development in Taxation

LIMITED PARTNERSHIP FUND ORDINANCE

On 9 July 2020, the Hong Kong Legislative Council passed the third reading of the Limited Partnership Fund Bill. The new ordinance introduces a limited partnership fund ("LPF") regime which enables funds to be registered in the form of limited partnership in Hong Kong. It will be separate from the Limited Partnerships Ordinance ("LPO") which will continue to apply to existing non-fund limited partnerships.

The Limited Partnership Fund Ordinance ("LPFO") will come into operation on 31 August 2020. In this Tax Flash, we will summarize the key features of the LPF regime and provide an update on the tax treatment for investment funds in Hong Kong.

1. KEY FEATURES OF THE LPF REGIME

LPF Regime	
Eligibility	• The fund must be constituted by a limited partnership agreement ("LPA") • Have one general partner ("GP") and at least one limited partner ("LP") • The fund cannot have all the partners from corporations in the same group of companies unless certain conditions are met • Must maintain a registered office in Hong Kong • The English name of the fund must contain the words 'Limited Partnership Fund' or 'LPF' as its last three words. The Chinese name must contain '有限合伙基金' as its last six characters
Contractual Freedoms	The partners in a LPF have freedom of contract in respect of the operation of the fund. A wide range of matters can be incorporated into the LPA, such as: - • the admission and withdrawal of partners in the fund; • the transfer of interests in the fund by the LPs; • the organization, management structure, governance and decision-making

	procedures of the fund; • the investment scope and strategy of the fund; • the powers, rights and obligations of the partners; • the scope of the fiduciary duties of the GP (and the authorized representative, if applicable); • the financial arrangements[1] among the partners such as capital contributions, withdrawal of capital contributions, distribution of proceeds, and clawback obligations; • the life of the fund with possibility of extension; • the frequency of financial reporting and verification of net asset value; • the custodial arrangement; and • the dissolution procedure.
General Partner (“GP”)	• GP may be one of the following: - - a natural person who is at least 18 years old; - a Hong Kong private company; - a registered non-Hong Kong company; - a limited partnership; or - a LPF • If GP is another LPF or a non-Hong Kong limited partnership without a legal personality, an authorized representative[2] must be appointed. • GP (and the authorized representative, if applicable) has ultimate responsibility for the management and control of the LPF and has unlimited liability for all the debts and obligations of the LPF.
Limited Partner (“LP”)	• LP may be a natural person, a company, a partnership or other body corporate. • LP has the right to participate in the income and profits arising from the fund. • Provided the LP does not take part in the management of the fund, its liability for the debt or obligations of the fund is, under the terms of the LPA, limited to the amount of its agreed contribution. • If a LP takes part in the management of the fund, the LP and GP (and the authorized representative, if applicable) are jointly and severally liable for all debts and obligations of the fund incurred. • Schedule 2 of the LPFO specifically provides a list of activities that a LP may engage in that will not be regarded as taking part in the management of the fund, such as: - - acting as or authorising a person to act as an agent, member, contractor, officer or employee of the LPF; - acting as or authorising a person to act as an agent, director, shareholder, member, contractor, officer or employee of the GP; - discussing with or advising the GP/another LP/investment manager; and - taking part in decisions of the LPF including change in the investment scope and appointment and cessation of GP or LP.

[1] *Withdrawal of capital contributions and distribution of profits are only permitted if the LPF remains solvent following such withdrawal or distribution.*
[2] *Must be a Hong Kong resident who is at least 18 years old, a Hong Kong company or a registered non-Hong Kong company.*

Investment Manager	• Appointed by GP to carry out the day-to-day investment management functions (GP itself can perform the role of the investment manager). • The investment manager may be a Hong Kong resident who is at least 18 years old, a Hong Kong company or a registered non-Hong Kong company. • The investment manager may be required to be licensed by the Securities & Futures Commission ("SFC") if it carries out regulated activities that falls under the remit of the SFC.
Registration of LPF	• Application must be submitted to the Hong Kong's Registrar of Companies by a Hong Kong law firm or a Hong Kong solicitor. • A LPF must keep records (e.g. register of partners, audited financial statements) at the registered office in Hong Kong (or other place in Hong Kong known to Hong Kong's Registrar of Companies) and be made available for inspection by law enforcement officers when necessary.
Tax Treatment	<u>Hong Kong Profits Tax</u> • A LPF meeting the definition of a "fund" under the Inland Revenue Ordinance can enjoy profits tax exemption provided it meets the exemption conditions. <u>Hong Kong Stamp Duty</u> • Interest in LPF is not considered as a "stock" under the Stamp Duty Ordinance. Accordingly, an instrument under which the LPF interest is contributed / transferred / withdrawn will not be chargeable to stamp duty in Hong Kong. • However, in-kind capital contributions in relation to the transfer of dutiable assets (e.g. Hong Kong stock or immovable property) would be subject to stamp duty.
Migration of Fund	• A fund already registered under the LPO can migrate onto the LPF regime. • The migration would not affect the identity and continuity of the fund (i.e. deemed not to have been dissolved) and will not be chargeable to profits tax and stamp duty in Hong Kong if there is no transfer of assets nor change in the beneficial ownership.
Others	• Independent auditor should be appointed by the GP to carry out audits of the LPF's financial statements. • A responsible person (must be an authorized institution, licensed corporation, accounting professional, or legal professional) should be appointed to carry out anti-money laundering and counter-terrorist financing functions. • A LPF may ordinarily be dissolved in accordance with the terms of the LPA.

2. UNIFIED TAX TREATMENT FOR INVESTMENT FUNDS IN HONG KONG

The Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Ordinance 2019 was effective from 1 April 2019. It introduces a new unified profits tax exemption for investment funds operating in Hong Kong, regardless of their structure, domicile, location of central management and control, size or investment objectives. Subject to meeting certain conditions, a fund may now enjoy tax exemption in connection with its investment in both overseas and local private companies.

To enjoy the profits tax exemption, three conditions must be met:

- The entity must qualify as a "fund" for the purposes of the exemption;
- The profits must be derived from “qualifying transactions” in assets of a class specified in Schedule 16C of the Inland Revenue Ordinance (“IRO”), transactions incidental to the carrying out of qualifying transactions (subject to a 5% threshold)[3] and (if the fund is an open-ended fund company (“OFC”) transactions in assets of a class not specified in Schedule 16C; and
- The “qualifying transactions” must be carried out or arranged in Hong Kong by a “specified person”[4], or the fund is otherwise a "qualified investment fund".

A special purpose entity (“SPE”) wholly or partially owned by a tax-exempted fund may also be exempted from profits tax on its assessable profits from transactions in certain securities in relation to an investee private company or an interposed SPE.

Classes of Specified Assets for “Qualifying Transactions”

Schedule 16C to the Inland Revenue Ordinance contains the list of 11 classes of assets specified for “qualifying transactions”: -

a) securities;
b) shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a private company;
c) futures contracts;
d) foreign exchange contracts under which the parties to the contracts agree to exchange different currencies on a particular date;
e) deposits other than those made by way of a money-lending business;
f) deposits made with a bank;
g) certificates of deposit;
h) exchange-traded commodities;
i) foreign currencies;
j) OTC derivative products; and
k) an investee company’s shares co-invested by a partner fund and The Innovation and Technology Venture Fund Corporation under the Innovation and Technology Venture Fund Scheme.

Where the “qualifying transactions” involve interests issued by private companies, additional conditions must be met. Please refer to Appendix 1 for the tests on eligibility for tax exemption in respect of profits generated from transactions in specified securities of a private company.

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[3] *Typical incidental transactions include custody of securities, and receipt of interest or dividend on securities acquired through the qualifying transactions. If the 5% threshold is exceeded, the whole of the fund’s trading receipts from the incidental transactions (i.e. not just the amount in excess of the 5% threshold) will be chargeable to profits tax.*

[4] *This includes a corporation licensed or registered for carrying out specified regulated activity under the Securities and Futures Ordinance and Hong Kong licensed managers.*

"Qualified Investment Fund"

A "qualified investment fund" refers a fund which:

- has more than 4 investors and the sum of their capital commitments exceeded 90% of the aggregate capital commitments; and
- not more than 30% of the net proceeds arising out of the transactions of the fund are to be received by the originator (e.g. sponsor of the fund, investment manager) and its associates, after deducting the portion attributable to their capital contributions (which is proportionate to that attributable to the investors' capital contributions);

The 30% threshold is intended primarily to deny tax exemption to funds the profits of which are simply siphoned to one single investor who may be the fund manager. The requirement also ensures that the vehicle is a bona fide fund (i.e. the fund is not simply a vehicle primarily owned by the fund manager with other investors holding a nominal interest).

Management Fee and Carried Interest

- Management fee accrued to the investment manager in Hong Kong should commensurate with the investment manager's functional and risk profile within the overall asset management value chain (i.e. the investment manager should be accrued an arm's length fee);

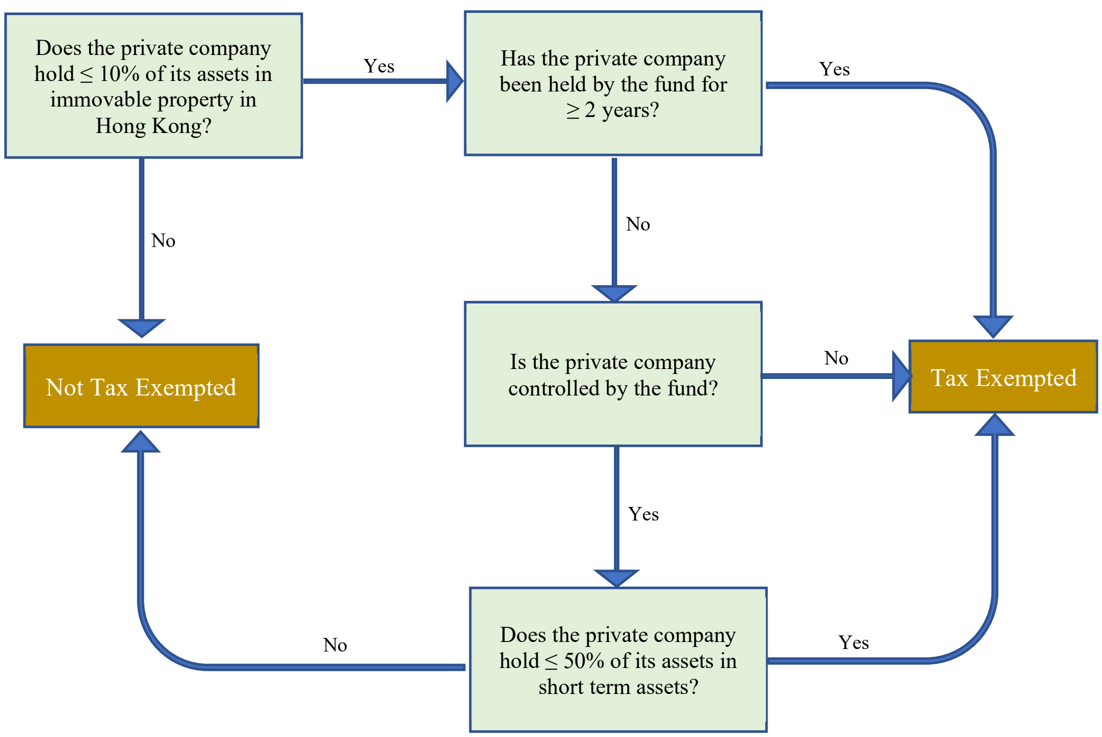
- During the budget speech in February 2020, the government has also announced its plan to introduce tax concessions for carried interest issued by private equity funds operating in Hong Kong, the details of which are to be further issued.

LOOKING AHEAD

Despite many Asian focused funds like to situate their investments teams in Hong Kong, it has been common for fund managers to establish their funds in offshore jurisdictions such as the Cayman Islands because of their well-developed regulatory fund regime. Having said that, many fund managers are now revisiting their structures as various new laws with more stringent reporting obligations (e.g. economic substance law) have recently been enacted in these offshore jurisdictions. In order to attract these players to choose Hong Kong as their new home, our fund regulatory landscape needed to be revamped to provide a more flexible and business-friendly environment. The enactment of the new LPF regime, the introduction of unified tax treatment for investment funds as well as the proposed carried interest concession should be welcomed by the industry and help attracting fund managers to set up/re-domicile their funds in Hong Kong.

Appendix 1

Tests on Eligibility for Tax Exemption in Respect of Profits Generated from Transactions in Specified Securities of a Private Company



Source: Appendix 3 of IRD's Departmental Interpretation and Practice Note 61

RSM Tax Advisory (Hong Kong) Limited

RSM Hong Kong's dedicated and experienced tax specialists can:

- Advise on tax efficient holding and operational structures for new cross-border investment, including the formation of Hong Kong and Chinese business entities
- Review existing cross-border investment structures, advise on identified deficiencies, quantify any potential exposure from such deficiencies, and further advise on restructuring approach and procedures
- Assist clients to discuss and clarify matters with tax officials, including transfer pricing and advance rulings
- Act as client representative in tax audits and tax investigations
- Provide transaction support services on mergers and acquisitions, including tax due diligence, deal structure advice, tax health checks, related human resources arrangements and other tax compliance and consultation services
- Advise on human resources and structuring employment arrangements in a tax-efficient manner
- Advise on tax equalization schemes
- Provide tax compliance services for individual and corporate clients in Hong Kong and China

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