



**PKF Hong Kong Tax Newsletter (August 2020)**

# Hong Kong Limited Partnership Fund Regime & Unified Profits Tax Exemption for Funds

The new Hong Kong Limited Partnership Fund Ordinance (Cap. 637) (“the New LPF Ordinance”), which establishes a new limited partnership fund (“LPF”) regime to enable private funds to be registered in the form of limited partnerships in Hong Kong, will come into effect on 31 August 2020.

The New LPF Ordinance was introduced to foster the position of Hong Kong as a premier international asset and wealth management centre. In conjunction with the Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Ordinance 2019 (“the Unified Regime Ordinance”) which came into effect on 1 April 2019, it is expected that Hong Kong will become an attractive location to set up private investment funds going forward.

As one of the key issues discussed in this newsletter, we will give a brief introduction to the Unified Regime Ordinance, which extends Profits Tax exemption to all investment funds, regardless of their form, size, purpose, or location of its central management and control, provided that certain conditions are met. We will also highlight some of the latest developments, including the recently published Departmental Interpretation & Practice Note No. 61 (“DIPN 61”) which sets out the Inland Revenue Department’s (“IRD”) interpretation of the Unified Regime Ordinance and the IRD’s views on carried interest.

**Key Issues:**

**The New LPF Ordinance**

Establishing private investment funds in the form of a limited partnership

**Unified Regime Ordinance**

Tax exemption extended to all types of investment funds

## The New Hong Kong Limited Partnership Fund Ordinance

Under Hong Kong's current legal framework, funds in Hong Kong are mainly established in the form of unit trusts or open-ended fund companies. In reality, however, many overseas fund managers prefer to establish their private investment funds in the form of a limited partnership. Therefore, the existing Hong Kong Limited Partnership Ordinance ("LPO"), which is typically used to establish professional practices such as accountancy, law, etc., does not provide an attractive framework to the fund industry.

To strengthen Hong Kong's private investment industry and facilitate the channelling of overseas capital into local markets, especially start-ups in innovation and technology fields, **the New LPF Ordinance has been enacted to provide an attractive legal framework for many overseas private investment funds (including private equity and venture capital funds) to set up, register and operate their businesses in Hong Kong.**

### Main features of the New LPF regime

An LPF is set up and used to manage investments for the benefit of its investors. Under the New LPF Ordinance, a fund qualifying for registration under the LPF regime must be constituted by one General Partner (i.e. operating person) and at least one Limited Partner (i.e. the investors) under a written agreement. Other key features of the LPF regime include (but are not limited to) the following:-

#### 1. Key Roles of an LPF



##### General Partner

- Must be a natural person, a Hong Kong private company limited by shares, a non-Hong Kong company registered with Hong Kong Companies Registry ("HKCR"), a limited partnership registered under the LPO, a limited partnership fund, or a non-Hong Kong limited partnership with or without a legal personality.
- Has unlimited liability for all the debts and obligations of the fund, ultimate responsibility for the management and control of the fund, and a duty to ensure proper custody arrangements for the assets of the fund as specified in the LPF agreement.



##### Limited Partner

- Can be a natural person (whether in the person's capacity as trustee, or in the person's own or any representative capacity), a corporation, a partnership of any kind, an unincorporated body or any other entity (whether in its capacity as trustee, or in its own or any representative capacity).

- Has the right to participate in the income and profits arising from the management of the assets and transactions of the LPF by the General Partner in, and the Investment Manager of, the LPF.
- Does not owe any fiduciary duty to the General Partner, or any other Limited Partner, in the LPF;
- Does not have day-to-day management rights or control over the assets held by the LPF and is not liable for the debts and obligations of the LPF beyond the amount of the Limited Partner's agreed contribution.



##### Responsible Person

- The General Partner in an LPF must appoint a "responsible person" to carry out the relevant measures set out in the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615).
- A responsible person of an LPF must be an authorized institution, a licensed corporation, an accounting professional or a legal professional). If a General Partner meets any one of these 4 categories, the General Partner may also be the responsible person.



##### Investment Manager

- Responsible for carrying out the day-to-day investment management functions of the LPF.
- Must be a Hong Kong resident, a Hong Kong company or a non-Hong Kong company registered with the HKCR.
- The General Partner may also be the Investment Manager if certain conditions are met.

## 2. Application for registration

An application for registration of a fund as an LPF must be submitted to the HKCR by a registered Hong Kong law firm or a solicitor admitted to practice Hong Kong law in Hong Kong on behalf of the proposed General Partner in the fund.

## 3. Registered office address

The registered office of an LPF must be situated in Hong Kong. "Care of" address and post office box number are not accepted.

## 4. Preparation of audited financial statements and other records

An LPF must appoint a local CPA (or a firm of local CPAs) to audit its accounts and issue a set of audited financial statements, which must be kept together with other documents and records of the LPF as specified by section 29 of the New LPF Ordinance.

## 5. Keeping of records

An LPF must keep the following records at its registered office in Hong Kong or any other place in Hong Kong made known to the Registrar of the HKCR:-

- the audited financial statements;
- a register of the partners of the LPF;
- records and documents obtained in the course of carrying out customer due diligence and files relating to every customer's account and business correspondence with the customer and any beneficial owner of the customer in accordance with the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615);
- documents and records of each transaction carried out by the LPF; and
- the controller of each of the partners in the LPF.

## 6. Migration of specified funds

If a fund set up in the form of a limited partnership registered under the LPO meets the eligibility requirements under the New LPF Ordinance, it can be migrated to an LPF by submitting an application to the HKCR.

## 7. Certificate of Registration of LPF and Business Registration

Upon completion of the registration process, the HKCR will issue a "Certificate of Registration" which is conclusive evidence that the fund is an LPF. The General Partner is required to apply for a Business Registration Certificate for the LPF from the Business Registration office of the IRD.

## 8. Confidentiality of Limited Partners

The identity of the Limited Partners would not be publicly accessible.

## 9. Hong Kong Profits Tax and Stamp Duty

An LPF can enjoy Hong Kong Profits Tax exemption provided that it meets certain conditions under the Unified Regime Ordinance.

Since an interest in an LPF does not fall within the definition of "Hong Kong stock" which is subject to Hong Kong Stamp Duty Ordinance, the contribution, transfer or withdrawal of interests in an LPF is not subject to Hong Kong Stamp Duty.

## Unified Regime Ordinance

The Unified Regime Ordinance which has come into effect since 1 April 2019, **extends Profits Tax exemption to all investment funds, regardless of their form, size, purpose, or location of its central management and control, provided that certain conditions are met.**

In the Unified Regime Ordinance, the IRD has removed the ring-fencing features of the previous fund exemption scheme, where profits tax exemption did not cover certain privately offered funds that operated in Hong Kong. The scope of tax exemption also covers special purpose entities (“SPE”) which are held by tax-exempt funds to the extent that relevant requirements are fulfilled.

The IRD published the DIPN 61 on 30 June 2020 to provide more guidance on the new fund exemption regime.

## Tax exemption under the Unified Regime Ordinance

In order for an investment fund to qualify for exemption from Hong Kong Profits Tax under the Unified Regime Ordinance, there are 3 main conditions which need to be satisfied:-

### 1. Definition of a “fund” under the Unified Regime Ordinance

The investment fund should possess the characteristics of a pooled investment or a collective investment scheme as defined in Schedule 1 to the Security and Future Ordinance (“SFO”). In particular, the Unified Regime Ordinance provides that a fund should satisfy the following:-

- (i) the arrangement must provide-
  - for the property to be managed as a whole by, or on behalf of, the person operating the arrangement (e.g. the General Partner of an LPF); or
  - for the contributions of the persons participating in the arrangement (“participating persons”) (e.g. the Limited Partners of an LPF) and the profits or income to be pooled; or
  - for both of the above; and

- (ii) the participating persons do not have day-to-day control over the management of the property even if they have the right to be consulted or to give directions in respect of the management of the property; and
- (iii) the purpose of the arrangement is for the participating persons to participate in or receive profits, income or other returns from the acquisition, holding or disposal of the property; or from the exercise, redemption or expiry of any right, interest, title or benefit in the property.

DIPN 61 provides several exemplary arrangements for a qualified fund under the Unified Regime Ordinance, which include a mutual corporation, an LPF, a trust arrangement, etc.

On the other hand, arrangements not meeting the above definition of fund would generally include group schemes where the participating persons are corporations in the same group of companies as the operator, single-investor funds, etc. As regards complex and multi-vehicle fund structures (e.g. master-feeder structures, parallel funds), they may be considered as one or more than one fund by the IRD depending on the totality of facts.

## 2. Profits derived from “qualifying transactions” and “incidental transactions”

The assessable profits derived by a fund from qualifying transactions as defined on Schedule 16C of the Inland Revenue Ordinance (“IRO”) and incidental transactions (subject to a 5% threshold) are specifically exempt from profits tax.

Incidental transactions refer to transactions incidental to the carrying out of the qualifying transactions, and typically include custody of securities and receipt of interest or dividend on securities acquired through the qualifying transaction. Please note that if a fund’s trading receipts from incidental transactions exceed 5% of the total trading receipts from qualifying transactions and incidental transactions taken together, then the whole of the funds’ trading receipts from the incidental transactions (i.e. not just the amount in excess of the 5% threshold) will be chargeable to Hong Kong Profits Tax.

Notwithstanding the above, the assessable profits derived from the transactions in relation to the investments in private companies by a fund or its SPE may only be exempt if the following tests are passed:-

- **Hong Kong immovable property test** – the investee private company does not hold more than 10% of its assets in Hong Kong immovable property; and
- **Holding period test** – the investment in the investee private company has been held for not less than two years; or
- **Short-term assets test** (only applicable upon failing the holding period test) – the fund or its SPE does not have a controlling stake in the investee private company; or the fund or its SPE has a controlling stake in the investee private company, but the investee private company does not hold more than 50% of the value of its assets in short-term assets.

One of the areas of uncertainty when the Unified Regime Ordinance was first gazetted on 20 February 2019 pertained to whether a SPE’s transactions in listed Hong Kong companies were exempt from profits tax as it is not specifically stated in the new provisions. The IRD clarified in DIPN 61 that by definition, SPE should not be holding listed companies. However, in the case that an SPE disposes of its holding in an investee private company through an initial public offering, the IRD may continue to grant the profits tax exemption provided that its arrangement qualifies for exemption under the Unified Regime Ordinance.

## 3. Qualifying transaction carried out or arranged in Hong Kong by “specified persons”

The qualifying transactions must be carried out or arranged in Hong Kong by a specified person in order for the profits derived by the fund to be exempt from profits tax. A specified person is defined in the IRO to mean a corporation licensed or an authorized financial institution registered under the SFO for carrying on a business in any regulated activity as defined by Part 1 of Schedule 5 of the SFO. As provided in DIPN 61, this would include a situation where a Hong Kong specified person arranges in Hong Kong to buy/sell stocks traded on the Tokyo stock exchange.

If this condition is not satisfied, the fund may still enjoy a profits tax exemption if it is a “qualified investment fund”, which is defined as a fund in relation to which

- (a) At all times after the final closing of sale of interests-
  - the number of investors exceeds 4; and
  - the capital commitments made by investors exceed 90% of the aggregate capital commitments; and
- (b) An agreement governing the operation of the fund provides that 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. the General Partner in an LPF) and the originator’s associates, after deducting the portion attributable to their capital contributions (which is proportionate to that attributable to the investors’ capital contributions).

## Other considerations

### Carried interest

Performance fees received by General Partners of an LPF are generally structured in two forms (or commonly a combination of both): (1) a management fee or (2) a carried interest which represents a share of any profits regardless of whether they contribute any initial funds. On its surface, it appears that carried interest is structured as the investment returns received by Limited Partners of an LPF and may be exempt from Hong Kong tax in a handful of scenarios. However, the IRD is currently of the view that carried interest may be treated as a fee and subject to tax in the hands of the manager or advisor operating in Hong Kong on the basis that such amount is essentially a remuneration for the investment management or advisory services being performed. In case the carried interest is treated as a fee and is paid between associated entities, such amount may also be subject to transfer pricing regulations in Hong Kong and may need to comply with the arm's length principle.

Despite the above, in order to promote Hong Kong as an attractive global center for asset management business, the Hong Kong Government has announced that it will be introducing a new tax concession for carried interest regarding private equity funds in the near future.

### Anti-round tripping provisions

The IRD has also included anti-round tripping provisions in the Unified Regime Ordinance to prevent abuse or round-tripping by resident persons to take advantage of the profits tax exemption. In particular, if a Hong Kong resident person, either alone or jointly with the person's associates, holds a beneficial interest (whether direct or indirect or both) of not less than 30% in a tax-exempt fund, or any percentage if the fund is the resident person's associate, the resident person is deemed to have derived assessable profits in respect of the profits earned by the fund from the qualifying transactions and incidental transactions carried out in Hong Kong. Where the fund has a beneficial interest (whether direct or indirect or both) in a SPE that is exempt from the payment of tax, the resident person is deemed to have derived assessable profits in respect of the profits earned by the SPE.

The tax implications of a fund (including an LPF) could be very complicated. It is recommended that anyone who is planning to set up a fund under the New LPF Ordinance should seek proper advice in advance to confirm the structure and potential tax consequences of the fund.

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