

Hong Kong

Taxation

HEDGE FUNDS 2009

Hedge fund managers/advisors

Taxation

Tax rates applying to hedge fund managers/advisors

Hong Kong has a territorial (or source) based taxation system whereby profits tax, generally speaking, is not levied based on the residency of the taxpayer.

A person, who carries on business in Hong Kong and is in receipt of Hong Kong-sourced income from that business, is prima facie liable to Hong Kong profits tax on such income. Dividends, capital gains (but not revenue gains), certain interest income and offshore-sourced profits are specifically exempt from Hong Kong tax.

If the hedge fund manager/adviser is incorporated as a company and/or carries on business in Hong Kong, it will be subject to profits tax (currently at the rate of 16.5 percent) on its taxable profits from that business. Distributions to the owners of the business will not be taxed, as dividends are specifically exempt from Hong Kong tax.

If the hedge fund manager/adviser is established as a partnership (regardless of whether it is a general partnership or limited liability partnership), it is viewed as a separate taxable person for Hong Kong tax purposes. Accordingly, a partnership will be chargeable to tax in its own name, although any tax unpaid by a partnership may be recovered from any partner. Where the partnership is formed by corporate partners and carries on business in Hong Kong, the partnership will be subject to Hong Kong tax on its taxable profits at the corporate tax rate. If the profits of the partnership have been subject to Hong Kong tax (which will be at the partnership level), the partners will not be subject to Hong Kong tax again on the after-tax distributions from the partnership.

The effective tax rate usually suffered by hedge fund managers/advisors

Given that only Hong Kong-sourced profits derived by a person from a business carried on in Hong Kong will be subject to tax, the effective tax rate will be

lower than the corporate tax rate (currently at 16.5 percent) if the fund manager/advisor derives offshore-sourced income (such as, income for services performed outside Hong Kong) and/or dividends.

Tax concessions, allowances, or exemptions specifically available to hedge fund managers/advisors

There are currently no concessions, allowances, or exemptions that are specifically available to hedge fund managers/advisors in Hong Kong.

Details of anti-avoidance tax rules that could bring the profits of an offshore hedge fund into tax

If any part of the offshore fund's investment activities is in substance managed in Hong Kong, it could potentially be considered to be carrying on business in Hong Kong through the fund manager/advisor. It follows that the fund could have a technical exposure to tax on its Hong Kong-sourced profits from that activity unless it qualifies for one of the statutory exemptions.

Requirements to charge VAT (or equivalent sales tax) and the rate

There are currently no indirect taxes in the nature of valued added tax or goods and services tax in Hong Kong.

Hedge fund structures

Taxation

Tax rates applying to the fund

Funds, unless otherwise specifically exempt, are subject to Hong Kong profits tax (currently at the rate of 16.5 percent for corporations or partnerships formed by corporate partners) if they carry on business in Hong Kong and generate Hong Kong-sourced trading profits from that business.

There are two specific exemptions available to funds which, subject to the relevant conditions being satisfied, operate to exempt certain or all of the fund's profits from tax in Hong Kong. They are the exemption for authorized or regulated funds and exemption for offshore funds.

Exemption for authorized or regulated funds

The first exemption applies to:

- a mutual fund or unit trust authorized under the Securities and Futures Ordinance; or

- a mutual fund, unit trust or similar collective investment vehicle which the Commissioner of Inland Revenue is satisfied is bona fide widely held and complies with the requirements of a supervisory authority within an acceptable regulatory regime.

If the exemption applies, all profits of the fund will be exempt from profits tax to the extent that the profits arise from investment activities which are in accordance with the fund's constituent documents and the requirements of the regulatory regime under which it operates. However, this exemption regime may not apply to the majority of hedge funds. This is due to the fact that hedge funds are often set up as private investment partnerships that are open to a limited number of investors (therefore may not be widely held) and they are mostly unregulated (unlike mutual funds) and cater to sophisticated investors.

Exemption for offshore funds

The other exemption is the exemption for offshore funds, which applies to a broader category of offshore funds and the legislation giving effect to the exemption was enacted in March 2006. The legislation introduced two new provisions into the Inland Revenue Ordinance – an exemption provision and a deeming provision.

Broadly, the exemption provision operates to exempt an offshore fund from Hong Kong profits tax where the fund is a non-resident person (a company, individual, partnership, or trust) and derives its profits from certain qualifying transactions carried out through or arranged by specified persons. However, the exemption will not apply where a non-resident fund carried on any business in Hong Kong that involves any transaction other than the qualifying transactions and transactions incidental to these qualifying transactions.

The definition of resident is central to the application of the exemption provision, as only a non-resident will qualify for the exemption. In the case of a corporation, partnership, or trust estate, the definition depends on where the relevant entity exercises its central management and control (CMC). The Hong Kong Inland Revenue Department (IRD) has indicated that the CMC requirement refers to the highest level of control of the entity concerned rather than day-to-day management of the entity.

The location of CMC is wholly a question of fact. In general, if CMC of a company is exercised by the directors in board meetings, the relevant locality is where those meetings are held. However, if CMC is in fact exercised by an individual, the place of residence of the company will be the place where that individual exercises his/her powers and not the place where the directors meet. If CMC of the fund is not exercised in Hong Kong, the fund can qualify for the offshore funds exemption notwithstanding that its asset portfolios are managed by a Hong Kong fund manager under his/her full discretion.

The exemption is intended to apply to most genuine offshore hedge funds and the scope of the qualifying transactions includes the typical transactions undertaken by hedge funds.

To prevent resident investors abusing the offshore funds exemption by disguising themselves as non-resident persons, the offshore funds exemption legislation contains anti-avoidance provisions to counteract potential abuse. These provisions can operate to deem a resident investor to be taxable on the Hong Kong-sourced profits of an exempt non-resident fund.

The exemption provision applies with retrospective effect to the year of assessment 1996/97. On the other hand, the deeming provision applies to the 2006/07 year of assessment onwards.

Funds not specifically exempt

For those funds that are not exempt and fall within the ambit of Hong Kong tax, such funds enjoy the general exemption from Hong Kong tax in respect of dividends, capital gains (but not speculative gains), certain interest income, and offshore-sourced profits.

The Hong Kong tax position of a fund is unaffected by whether or not the income of the fund is distributed.

Access to double tax treaties

Hong Kong has comprehensive double tax agreements with Belgium, Thailand and more recently, with Mainland China, Vietnam, and Luxembourg. The Hong Kong Government is presently in the process of negotiating a double tax agreement with Italy and the Netherlands.

Hong Kong also has tax treaties with other jurisdictions, but these principally relate to shipping and airline income.

Value-added tax registration and charging requirements

There are currently no indirect taxes in the nature of valued added tax or goods and services tax in Hong Kong.

Withholding tax on dividends or interest payments

No withholding tax is levied in Hong Kong on dividends and interest. Capital gains are not subject to tax in Hong Kong.

Tax return requirements

If the activities of a fund or its agent(s) amount to the carrying on of a business in Hong Kong, the fund has to notify the Hong Kong Inland Revenue Department within four months after the end of the accounting period in which it commences to earn assessable profits in Hong Kong and file tax returns.

Investors

Taxation

Specific anti-avoidance tax legislation applying to an investor in an onshore fund

Not applicable

Specific anti-avoidance tax legislation applying to an investor in an offshore fund

If the fund qualifies for the exemption for offshore funds, resident investors should be aware of the potential application of the deeming provision, which is an anti-avoidance provision in the offshore funds exemption legislation.

These provisions will apply to a Hong Kong resident investor having a beneficial interest of 30 percent or more (on an associate inclusive basis) in the non-resident fund or any beneficial interest (that is, no minimum threshold) in an associated non-resident fund.

Where the deeming provision applies, it effectively looks through the fund structure to deem a resident investor in the exempt non-resident fund to be taxable on his/her share of the Hong Kong-sourced trading profits derived by the exempt fund. This is the case regardless of whether the relevant profits of the fund have been distributed to the investor. The deeming provision will not be invoked in respect of offshore profits, capital gains, or dividend income.

The non-resident fund's tax position is unaffected by the operation of the deeming provision.

Tax information needs of investors

Resident investors who invest in collective investment funds established outside of Hong Kong are not subject to tax on dividends or other distributions of either income or capital, unless the receipts are considered to arise from a business carried on in Hong Kong. Even in such circumstances, as a matter of practice, the exemption from profits tax of dividends operates to ensure that no liability to tax arises to the individuals.

Non-distributed income or capital gains of a fund should not give rise to any tax liabilities for individual investors. However, one possible exception to this general rule is where the deeming provision in the offshore funds exemption legislation applies. In such situations, the investor will be required to report to the IRD on his/her share of the Hong Kong-sourced trading profits derived by the exempt offshore fund.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.