The Rise of the Asian Corporate Fund Vehicles –

Should Europe be afraid? | By Sophie Wong

Historically, Hong Kong and Singapore as fund domicile locations are less attractive to international players due to a lack of fund structure choice for asset managers – namely a corporate form vehicle that caters to the specific needs of hedge funds, private equity funds, mutual funds or real estate funds.

The answer from both governments to strengthen their position as an international fund domiciliation centre, is to launch a corporate form open-ended investment vehicle. In July 2018, Hong Kong launched the Open-Ended Fund Company (OFC) with much fanfare, and Singapore will be launching the Variable Capital Company (VCC) imminently.

But will these new Asian fund structures pose a threat to the status quo? The fund domicile of choice for global funds has been dominated by Luxembourg and Ireland, who have had corporate form investment vehicles since 1983 and 1990, respectively, as well as providing an established regulatory, tax and legal framework and support for the funds industry.

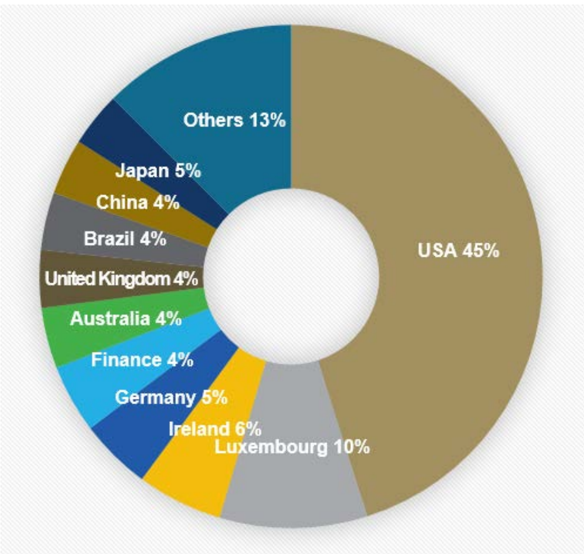

Figure 1: Top 10 Domiciles of Worldwide Investment Fund Assets
(Market Share at end Q1 2018, source from efama)

The OFC and VCC have been hailed as the Asian version of the long established Luxembourg Société d'investissement à capital variable (SICAV) and the Irish Collective Asset-management Vehicle (ICAV). Luxembourg and Ireland rank among the top three largest fund domiciles in the world (after domestic USA funds) with Luxembourg taking 9.5% and Ireland 5.5% of the market share. So will the new OFC and VCC be able to gain popularity and capture a percentage of the market share of these fund domiciles? And will they become the new vehicle and fund domicile of choice for asset managers? Perhaps, perhaps not.

Tax – a barrier to entry?

There are murmurings in the industry that the Hong Kong OFC is unlikely to gain traction due to tax conditions. Not only is the transfer of shares of an OFC subject to stamp duty, but the unauthorised (non-publicly offered) OFC is exempt from tax on profits only if it meets certain qualifying conditions which have been deemed as onerous and impractical, thus carrying too much tax risk; particularly the investor and monitoring requirements. The existing profits tax exemption for public funds will apply to publicly offered OFCs. However, for non-publicly offered OFCs, there is a strict qualifying criteria based on the composition of investors in the fund which must be non-closely held, and to add to the complication, there is a risk of exemption being non-applicable from Day 1 if it does not satisfy the non-closely held rule for up to 4 years. Certain Hong Kong investors can be deemed taxable even if the fund itself is exempt. Exemption is also applied on a sub-fund by sub-fund basis, so one sub-fund could be exempt and one might not.

On the other hand, the preliminary Singapore VCC tax framework announced the VCC will be treated as a company and a single entity for tax purposes regardless of whether it is a standalone or an umbrella fund. The tax exemptions under the Singapore Resident Fund Scheme (SRF) and the Enhanced-Tier Fund (ETF) Scheme will apply to VCCs as well as the existing Goods and Services Tax (GST) remission for incentivised funds. This means the VCC will need to submit incentive applications to the Monetary Authority of Singapore (MAS) for tax exemption approval - it is not automatic and there are specific conditions the VCC has to meet which differs between the schemes. Both schemes are required to have a Singapore based fund administrator and adherence to an investment objective condition at the umbrella level; thus a breach on a sub-fund level will render the entire fund taxable. Moreover, subsequent additions of new sub-funds to the umbrella will need to obtain approval if it has a different investment objective than what was previously approved. This is where the tax simplicity of a Luxembourg SICAV and the Irish ICAV makes these vehicles relatively more ideal, since the fund simply does not pay tax. Currently, there is no income tax, subscription tax, corporation tax or stamp duty on issue, transfer, repurchase or redemption of units for Irish funds and they are exempt from Irish tax on their income and gains, insofar as the fund does not have any Irish taxable investors. Luxembourg SICAVs are subject to an annual subscription tax, known as the "tax d'abonnement", otherwise the fund is not subject to any further taxes. There is absolutely no need for any complicated monitoring or adherence to strict conditions to ensure exemptions apply.

Large treaty network? Not that simple

Neither Hong Kong, Singapore, Ireland nor Luxembourg impose any local withholding tax on the fund's distributions, so treaty access is the least important factor to consider tax-wise. Most fund domicile marketing collaterals promote their country's large tax treaty network as a reason to choose their jurisdiction. This may be true as the country has access but does this apply to the fund vehicle?

The ability of investment fund corporate vehicles to access the Double Taxation Treaty network has been under scrutiny for some time as most standard taxation treaties require the fund to be "resident for tax purposes" in one or both of the contracting states. In other words, the investor's worldwide income needs to be subject to domestic corporation or income tax for them to be able to access any treaty benefits. In general, most investment funds do not actually pay any local tax on their worldwide income.

Here is the conundrum: An investor would prefer its fund to be tax neutral and tax exempt at the fund level, but also wants its fund to be deemed to be paying tax so that the investor can access treaty benefits! Treaty access for investment fund vehicles is not as clear-cut as how many treaties the country of domicile has access to, but rather how many treaties can a particular fund structure be eligible for.

Treaties are not the only way a fund can achieve higher returns on its investment via optimising withholding tax rates. A number of European countries provide domestic withholding tax exemptions for investors who reside in the European Union (EU) or European Economic Area (EEA) such as Spain, Greece, France just to name a few. Luxembourg and Irish funds enjoy this benefit being part of the EU, however funds domiciled outside of the EU or EEA such as the new Hong Kong OFC and the pending Singapore VCC will not be able to access these exemptions, making these fund vehicles far less attractive for asset managers investing into the European market.

Final musings

Will these new fund structures be a game changer? Probably too early to tell. So far there have been no OFCs listed on the Hong Kong Securities and Finance Commission and further details on the VCC tax framework will be released in due course.

Whether the VCC can compete on a global level with the existing European comparable structures depends on whether Singapore will learn from industry feedback and reaction to the launch of the OFC. If Singapore manages to get the tax right, the world could literally be its oyster.
