Asia's new fund passports pose tax questions

Asset Management Insights

This is part of a series of articles that focus on the theme of 'Mastering tax complexity within asset management'. It forms part of our flagship online publication for communicating key asset management issues to our clients on a quarterly basis.

Our specialists will use our online platform to keep you informed about our latest thinking on critical topics such as growth, governance, people, regulation and risk management developments globally.

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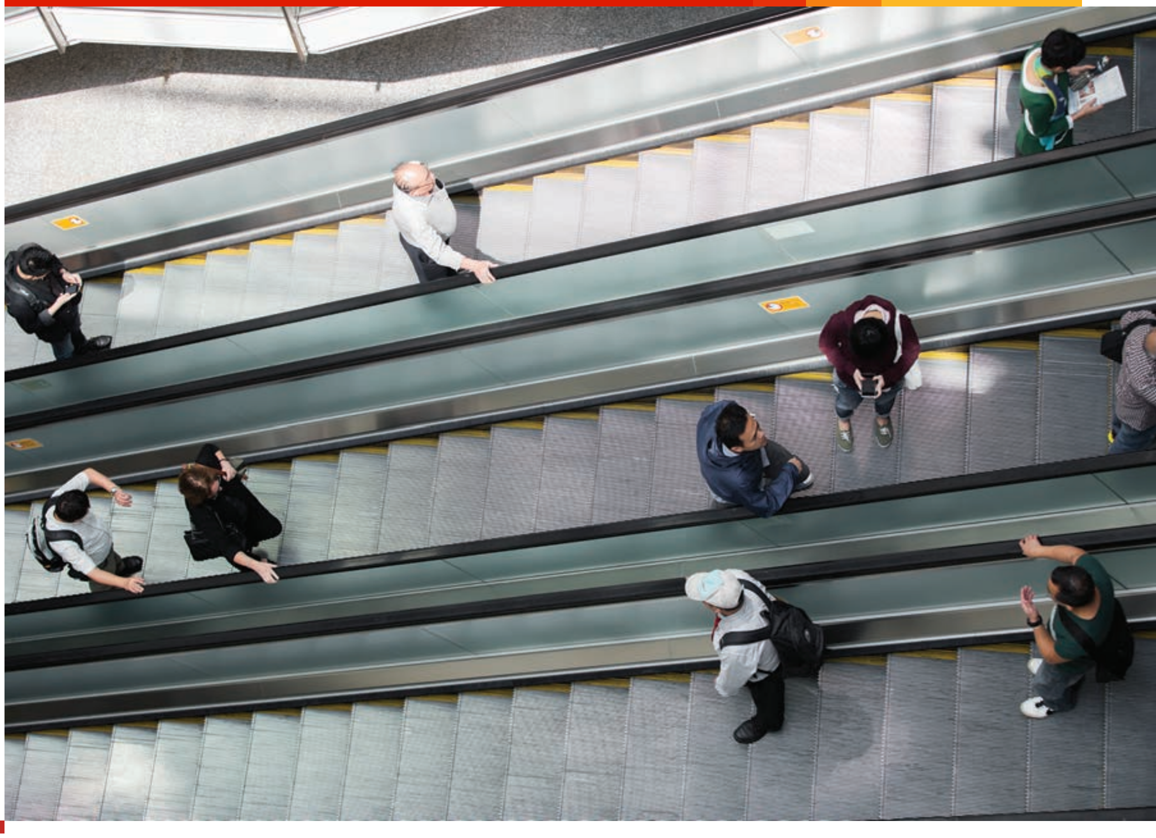

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Fund passports are becoming a reality in Asia, but their success depends in part on accompanying tax reforms.

The growth of Asia's capital mobility and financial markets has led to the development of fund passport regimes, allowing funds formed in one jurisdiction to be marketed with another with minimal regulatory hurdles. Yet there's a strong feeling that their success depends on the removal of tax obstacles.

In Europe, discriminatory tax treatment of Undertakings for Collective Investment in Transferable Securities (UCITS) funds has led to numerous law suits over the past 15 years. For example, the European Free Trade Association (EFTA) Fokus Bank case against Norway in 2004. Most European Union and EFTA member states have subsequently abolished dividend withholding taxes which been levied unlawfully on distributions to foreign funds.

Yet in Asia, where no supra-national legal framework exists to guarantee certain rights and freedom for market participants, this matter has not been addressed. Is there a regional mechanism to administer, supervise and enforce anti-discrimination rules? The aim should be for non-discriminatory treatment of passport funds and their investors.

As yet, there is no clarity as to how the emerging passport fund regimes will address the critical tax issue. It is important across all three regimes: the Asia-Pacific Economic Cooperation (APEC) Asia Region Funds Passport (ARFP), the Association of Southeast Asian Nations (ASEAN) Collective Investment Scheme (CIS) and the Mainland-Hong Kong Mutual Recognition of Funds agreement.

Without doubt tax outcomes influence investors' choice of investment products.

Asia Region Funds Passport

The Asian Region Funds Passport (ARFP) is planned to start in 2016. In September 2015, the finance ministers of Australia, Japan, Korea, New Zealand, the Philippines and Thailand signed a statement of understanding confirming their commitment to join. A draft Memorandum of Understanding setting out the passport's framework should be finalised in 2015. It is anticipated that eligible APEC economies would implement the ARFP in local legislation within the following 12 months.

There is a strong feeling that unless the tax aspects are addressed, the passport will not succeed.

There are a number of key tax principles which should be incorporated in the ARFP to achieve tax neutrality:

- Create a level playing field regarding investor returns
- Remove tax barriers impeding cross-border distribution
- Preserve tax neutrality through collective investment schemes
- Preserve integrity by mitigating tax evasion.

The questions that will need to be addressed at each level are:

The investor level

- How is the investor taxed if investing in a foreign fund versus a local fund?
- Are there any withholding taxes that apply?
- Are there any concessions that apply to local investors versus foreign investors?
- Are there any integrity measures that apply?

The fund level

- Is there any tax at the fund level?
- How is the fund taxed on its local investments versus foreign investments?
- Do the tax attributes of the investment flow to investors (ie transparent treatment of funds)?

Under the current taxing regimes for each participating economy there are some significant differences in investors' tax outcomes.

Without doubt tax outcomes influence investors' choice of investment products. So, to what extent can anti-discrimination measures make sure that the viability and competitiveness of funds from participating economies are not adversely affected?

Careful consideration of such measures will need to be undertaken, which may include:

- Passport funds are not subject to tax
- No withholding tax on distributions from the passport fund and distributions from investee companies
- Passport funds are exempted from capital gains on the disposal of investee companies
- Participating countries are required to adopt the the Organisation for Economic Co-operation and Development (OECD) Common Reporting Standard or other integrity measures.

ASEAN CIS

The ASEAN CIS is now a year old, and has shown a slow but promising start. Its participating countries are Singapore, Malaysia and Thailand. A few regionally dominant asset management houses have launched schemes, which are in various regulatory approval stages in the three participating countries.

The tax issues are similar to those affecting the ARFP.

For Mainland China investors, the question of whether the existing tax incentives for mutual funds in Mainland China could be extended to Hong Kong Hong Kong Securities & Futures Commission (SFC) authorised funds remains unanswered.

Hong Kong-China Mutual Recognition of Funds (MRF) scheme

After more than two years of speculation, the MRF was implemented on 1 July 2015, laying a foundation for greater integration of the Asian asset management industry. The MRF opens up the Chinese retail and institutional investors' huge savings pool to Hong Kong and international asset managers. In return, Hong Kong will offer Chinese investors a more diverse range of fund products.

Tax

The potential PRC tax implications for non-resident investors receiving income from a mainland fund recognised by Hong Kong's SFC are unclear. It is reasonable to expect that taxation rules will be similar to those on non-resident investors receiving income from QFII/RQFII or Shanghai-Hong Kong Stock Connect, ie mutually recognised funds will be tax exempt. But without such a clarification, it is challenging for asset managers to decide how to disclose the potential tax implications in their offering documents. For Mainland China investors, the question of whether the existing tax incentives for mutual funds in Mainland China could be extended to Hong Kong SFC authorised funds remains unanswered.

Qualified Hong Kong-domiciled funds, authorised by the SFC under section 104 of the Hong Kong Securities and Futures Ordinance, are statutorily exempt from Hong Kong profits tax. There is no Hong Kong profits tax on any distribution made by such an authorised fund to its investors (whether resident, non-resident, corporate, or individual).

Conclusion

There is a significant risk that if left unaddressed, tax discrimination will arise under Asia's fund passports and will undermine their effectiveness. In particular, ARFP investors will have to consider taxation as a key factor when choosing a fund product, as funds established in certain ARFP countries may suffer performance drag from excessive corporate income taxes and/or withholding taxes.

Further details of the tax treatment of domestic and foreign funds in Asian countries can be found in Funds Passport Regimes in Asia Pacific: Taxing Issues http://www.pwc.com/sg/en/asset-management/assets/funds-passport-regimes-in-asia-pacific.pdf.

For further details of current tax changes in Asia see Asset Management Tax Highlights Asia Pacific: http://www.pwc.com/sg/en/asset-management/assets/funds-passport-regimes-in-asia-pacific.pdf.

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