

# GETTING STARTED IN VENTURE PHILANTHROPY IN ASIA

LEGAL FRAMEWORK PROFILE  
for HONG KONG SAR

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**C L I F F O R D  
C H A N C E**

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for HONG KONG SAR

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AVPN would like to thank Karen Wong, Amy CK Lo and Ka Bo Lai of Clifford Chance for preparing the information in this country profile on a pro bono basis. For more information please contact the contributors as listed in the introduction of the country profile. We would also like to thank Elaine Tan.

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**About Business Families Institute @ Singapore Management University (BFI @ SMU):**



SMU established BFI @ SMU to be Southeast Asia's first business family centric institute focused on addressing the needs of business families in the region through its vision to facilitate business families to think generations, think growth and think giving. BFI @ SMU intends to serve as an educational, engagement and research platform to bring together business families, drawing on the university's experience to offer insights on issues such as business succession and family ownership. Its mission is to engage and enable business family members to be active, committed and involved stewards, stakeholders and partners through learning and education.

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Where amounts in the reports have been converted from local currency to US dollars the following exchange rate have been used for reference: US\$1= HK\$7.75 (source oanda.com average rate for CY 2013, midpoint interbank rate). The amounts will change based on actual exchange rates and changes to the underlying costs, fees and charges from the date of this report.

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LEGAL FRAMEWORK PROFILE  
for HONG KONG SAR

WITH THE SUPPORT OF :

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# INTRODUCTION TO THE LEGAL FRAMEWORK AND COUNTRY PROFILES

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The country legal framework profiles are companion booklets to AVPN's "Getting Started in Venture Philanthropy in Asia - a practical guide to establishing and operating a venture philanthropy or social investment organisation". The guide explains the key operational issues and the separate country legal frameworks focus on legal issues to supplement the main guide. The guide and each country profile are available to download from [www.avpn.asia/startVPO](http://www.avpn.asia/startVPO).

### **1. Overview of the Legal Framework**

There are corporate law, charities law, tax law and possibly financial regulatory fund raising and fund management issues, arising at different levels of the venture philanthropy (VP) eco-system. Some venture philanthropy organisations (VPOs) want to attract foreign as well as domestic funds and so factors affecting the cross-border flow of funds in the VP eco-system are critical considerations to these VPOs. As VP investments cover the spectrum from charities to social enterprises, the analysis of funds flows from top level funders to VPOs as intermediaries, and to social purpose organisations (SPOs), needs to consider both donations and a range of other financial instruments. The flow in the return direction of social impact (monitoring and reporting) and financial return (in the case of social investment) is equally important.

Some Asian countries (e.g. Singapore and Hong Kong) are already major financial centres and want to attract regional or offshore philanthropic and social investment funds. They have well developed cross-border fund management laws and regulations and skilled investment practitioners that apply to these activities.

This introduction describes the framework used for each of the five country profiles that have been prepared with the pro bono support of leading law firms. These profiles are available for download in softcopy - see the end of the introduction.

### **2. The Three Level Perspective of the VP Eco-system**

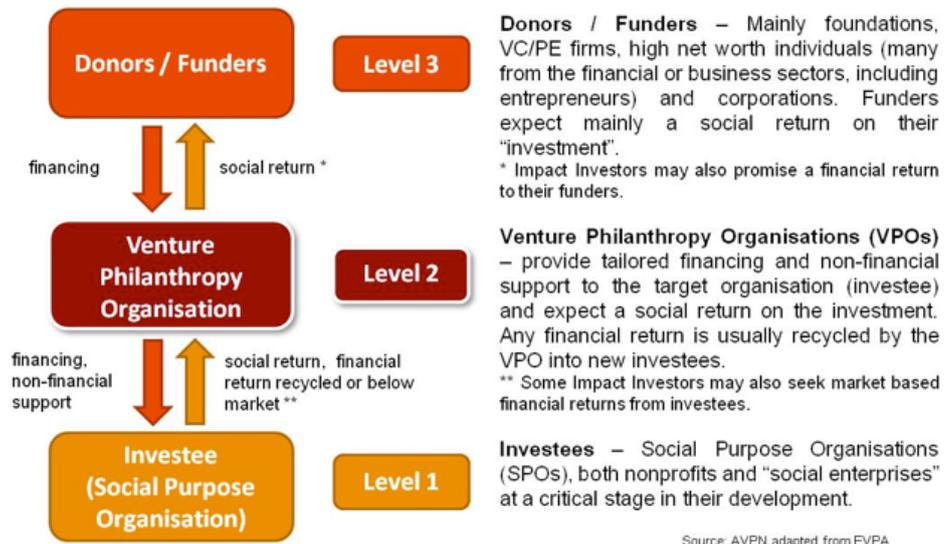
For this legal framework section and the stand alone country profiles our approach is to consider the venture philanthropy eco-system as operating on three same three levels in the main section of the AVPN report "Getting Started in Venture Philanthropy in Asia". The top level (Level 3) comprises the funders seeking social returns, the middle level (Level 2) comprises the VPO intermediaries that raise funds and deploy the funds through various VP strategies and the bottom level (Level 1) comprises SPOs seeking resources (financial, human and intellectual capital) to grow their activities.

These three levels represent a flow from end suppliers (level 3), through specialist intermediary suppliers (level 2) to the demand side (level 1) which serves a range of beneficiaries / customers / service users.

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This is shown in Diagram 1 as follows:

### VPO funding model – three levels



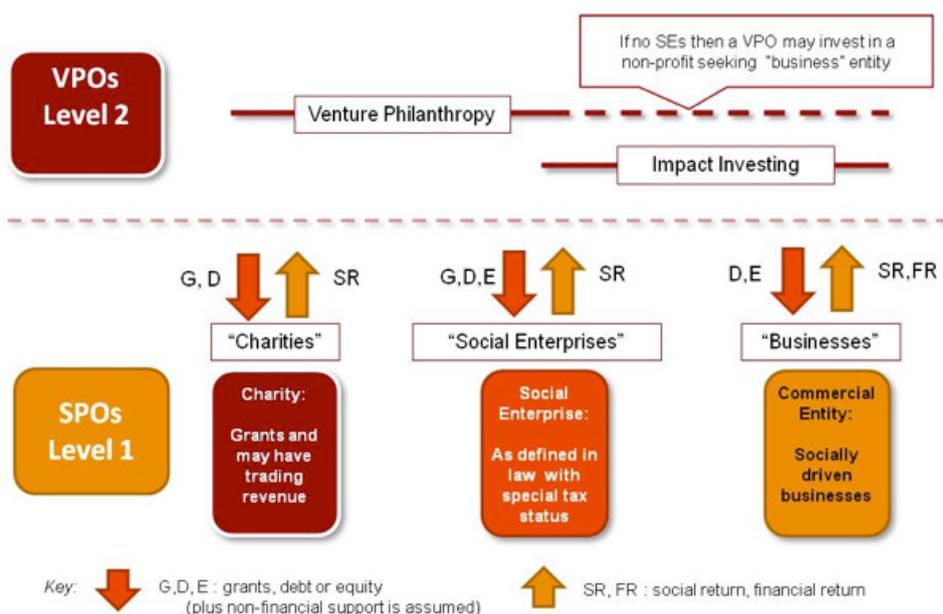
As the primary social impact is generated at the base of the eco-system and flows up, we start the analysis of legal entities at Level 1 which is the investee Social Purpose Organisations (SPOs) that are commonly available in each country. The choices of entity for VPOs at Level 2 of the eco-system are often similar to the entities used by SPOs at Level 1. The sources of funding flowing down from Level 3 may be donations/grants or, depending on the VPO strategy, other financial instruments such as debt and equity. Some VPOs at Level 2 may have a hybrid investment strategy in SPOs (i.e. grants, debt and equity) and so receive hybrid funding. VPOs decide whether they want to re-cycle financial return from their investee SPOs to fund their own costs and make new investments, and/or make distributions to their funders. A related choice is whether the VPO is a limited life organisation, raises new rounds of funding from time-to-time, or is intended as an evergreen vehicle that is self sustaining.

#### 3.Choice of Entities for Social Purpose Organisations at Level 1

There are a wide range of legal entities that may be available for SPOs at Level 1 but these can be broadly grouped as Charities, Social Enterprises and Commercial Entities (or Businesses). In the five countries considered by this framework there are no separately defined legal entities that are “Social Enterprises” -that is entities that they have special tax status and are effectively a hybrid between a business entity and a charity.

A list and description of the main types of SPO in a country is a basic building block of the legal framework profiles in the country profile reports.

For each country profile, the simplified investee SPO choices and available financing instruments are shown in Diagram 2 below:



In some countries social businesses (and social entrepreneurs) may be attracting investment for only social return, or for a mix of social and financial returns. These entities are often commercial entities which have a social mission and may adapt their governing documents to prohibit distributions and/or restrict transfers of ownership so that they become social "impact first" or "impact only" organisations.

#### 4. Choice of Entities for Venture Philanthropy Organisations at Level 2

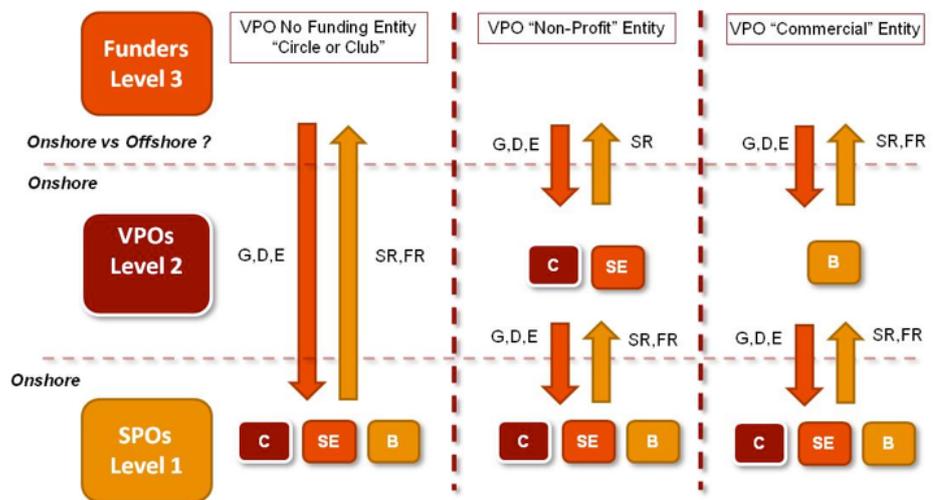
A VPO consists of a management team and a source of funding. These are often contained in a single legal entity but may be separated into a "fund" entity and an advisory (or consulting) entity.

Building on the SPO entity types and financial instruments that can be used to fund them, the legal framework country profiles consider three generic VPO operating models that are adapted and commonly used in Asia. The sponsors of a new VPO will likely choose a variation of one of these three models depending on the resources available to the VPO, its investment strategy and country of operation. The most important decision factor is whether the VPO wants to follow a grant approach, a social investment approach or a hybrid, i.e. whether the VPO will seek investee SPOs that provide both social and financial returns, and whether the VPO offer its funders both social and financial returns.

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The generic flows of funding and target social and/or financial returns are shown for the three models in Diagram 3 below:

**Three basic VPO legal models for analysis**



The three operating models (above from left to right) are:

- (1) A “virtual fund” where the fund itself is not a legal entity and the VPO operates as a consulting company. This model may be called a “social impact circle” or “social investor club” or simply a “venture philanthropy advisor). Examples include Dasra (India) and Asia Philanthropic Ventures (Singapore).
- (2) A VPO entity which only offers social return to its funders. This model may be called a “venture philanthropy fund” or a “venture philanthropy foundation” and is often a charity and/or foundation.
- (3) A VPO entity which offers both social and financial return to its funders and operates as an “investment fund” in the form of limited partnership or investment holding company, or other commercial entity, that can tax efficiently receive financial returns from SPOs and provide financial returns to its funders.

One of the main differences between more traditional venture philanthropy “investing” using grants and social investment is the promise and ability of the VPO to transmit a financial return from Level 1 to Level 3 through its activities at Level 2.

**5.Executive Summary of the Five Countries Profiled**

Given the depth and breadth of information provided by the various law firms for the five jurisdictions, it is useful to provide a high-level observation of some of the key highlights of each country’s legal landscape insofar as it relates to establishing a venture philanthropy organisation (VPO) in Asia.

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### **Singapore**

While there is no legal entity that is a hybrid between a charity and a traditional commercial entity in Singapore, the majority of charities and non-profit organisations in Singapore are established in the form of a company limited by guarantee (CLG) i.e. the liability of its members is limited by its constitutional documents to such amount as the members undertake to guarantee. While a CLG can accept donations and grants, it is unable to receive funding in the form of equity as it does not have share capital. Conversely, a CLG may accept debt funding insofar as it does not contravene the provisions of its constitutional documents although the receipt of debt funding may have implications under the Securities and Futures Act (SFA).

A CLG may be, in turn, registered and regulated as an approved charity in Singapore in order to enjoy full income tax exemption on income and receipts. In relation to the use of charities as a vehicle for venture philanthropy, the guidelines issued by the Office of the Commissioner for Charities (OCC) is relevant as it discourages charities from engaging in activities which exposes the charity's assets to significant risk. As such, although the investment of charity funds is not strictly prohibited, the OCC advises such charities to set up a separate business subsidiary for business activities where such business activities are not related to the primary purpose of the charity.

In relation to Level 2 VPOs in the form of CLGs or otherwise, the restriction is that they cannot distribute profits to its stakeholders (be they founders or members) if the VPO is a registered charity or entities that have special charitable status. Although a VPO may be able to pay interest on loans taken from its members, this is subject to any restrictions provided in its constitutional documents. Further, as a non-profit VPO is supposed to carry out wholly charitable purposes, it is unlikely to be able to make either an offer of securities or carry on business as a regulated activity, both of which will trigger the relevant financial regulatory restrictions or the Moneylenders Act. For these reasons, it is also unlikely to be able to give loans to Level 1 SPOs and expect returns thereon.

### **Hong Kong**

The legal position in Hong Kong is very similar to that of Singapore in that most charitable organisations are CGLs. As a general observation, most charities in Hong Kong are funded by donations and grants. Debt funding is uncommon (and will depend on any restrictions contained in the constitutional documents) and equity funding is generally inapplicable given that most charities are CGLs, societies or set up as a trust. Similar tax exemptions apply to both Singapore and Hong Kong for Approved Charities that continue to have a charitable purpose. In the context of the proposed VPO models which imply a flow of funds to and/or from a profit-driven commercial entity, this may breach the on-going charitable purpose compliance requirement.

In relation to the "No Funding" Entity Model, this is often the simplest model as there is no intermediate VPO entity and the funding will flow directly from the funder to the SPO. However, funders providing funding to the Level 1 SPO through debt may trigger the requirements of the Money Lenders Ordinance (MLO). Another complication is that the constitutional documents of the Level 1 SPO (assuming that it is an Approved Charity for tax reasons) may and probably should prohibit the distribution of income. Therefore, financial returns to a funder may not be permissible. In relation to the Level 2 VPO "Non-Profit" Model, there are additional twin complications of (a) whether a Level 2 VPO that is an Approved Charity would be permitted to provide funding to a Level 1 SPO, and (b) whether a Level 2 VPO that is an Approved Charity can provide a financial return to the Level 3 Funders. In order to overcome these impediments, the Level 2 VPO "Commercial" Entity Model may be the most viable structure if the flow of financial returns is imperative although such an entity would not have the tax benefits accorded to the an Approved Charity.

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### **China**

In China, entities that are able to carry on charitable activities usually take on one of these three structures: social organisations, foundations and private non-enterprise entities. Briefly, a social organisation is membership-driven, whereas foundations are not-for-profit organisations funded by assets donated for public welfare purposes and, lastly, private non-enterprise entities are social institutions established with private capital for the purpose of providing social services. Not-for-profit organisations in these three forms are prohibited from distributing financial returns to their members and sponsors. Further, for these three types of organisations, the key issues center on the legality of the source of funding as well as the use of funds.

As with Singapore and Hong Kong, these not-for-profit organisations in China are usually funded by donations and grants. Further, as these charitable structures do not have share capital, equity funding is not an option. As for debt funding, even where there is no explicit prohibition in the constitutional documents, they do not typically borrow as a matter of practice to fund their charitable activities. To understand this situation further, if these organisations attempted to be a Level 2 VPO “Non-Profit” Entity, the major impediment would be that in China, only banks and qualified financial institutions are able to extend loans. As such, if the Level 2 VPO wanted to extend a loan to a Level 3 SPO, it could only do so through the entrusted loan model where the Level 2 VPO provides funds to a financial institution that is qualified to conduct lending, and that financial institution would extend the loan to the Level 3 SPO as the lender.

### **Japan**

Charities in Japan are broadly categorized as (a) non-profits, (b) associations (2 types) and (c) foundations (2 types), all of whom enjoy varying tax benefits on their charitable or authorised activities subject to compliance with applicable requirements. However, these entities are not permitted to distribute profits to their members and/or they are not permitted to return funds to their members or contributors. That said, the legal profile suggests that these entities are permitted to accept debt funding except that for non-profits, they cannot facilitate the profit of a particular person (in this case, it would presumably be the lender). Interestingly, only associations and foundations may accept equity funding although for foundations, equity funding can only be done at incorporation and not subsequently.

The analysis for Level 2 VPO “Non-Profit” Entities is relatively simple as it is generally accepted that charitable organisations in Japan are prohibited from distributing profits and the legal profile implies, by extension, that such charitable entities are not permitted to provide funds to Level 1 SPOs. Further, as with the other jurisdictions, the potential triggering of the Money Lending Business Act is such that it would not be practicable for charitable organisations to apply for the licenses in order to extend loans to the relevant Level SPOs. Further, the legal profile suggests that any return of funds (whether debt or otherwise) by the Level 2 VPO “Non-Profit” Entity would be fraught with obstacles which is understandable as the establishment of VPOs is still a relatively new development in Japan.

## India

Various forms of social entrepreneurship models are used in India depending on their areas of operation and business requirements. Thus, social enterprises may opt for the revenue model, hybrid model or the venture capital model depending on the relevant financial viability and desired social outcomes. Interestingly, in India, a Level 1 SPO may be set up pursuant to Section 8 of the Companies Act (2013) as a not-for-profit company or pursuant to the Alternative Investment Fund Regulation (AIF Regulation) where an alternative investment fund (or a social venture fund) can be established or incorporated in India in the form of a trust, a company or a limited liability partnership.

However, these structures have inherent restrictions. For example, the aforementioned not-for-profit company is prohibited from distributing dividends to its shareholders. In comparison, the legal profile suggests that the aforementioned social venture fund may enjoy a “pass through” benefit under the relevant sections of the Income Tax Act such that income accruing to the social venture fund would be deductible in the hands of the investor. In comparing the various structures available to establish a VPO in the various countries, it appears that India’s albeit nascent development in this area is probably gaining the most traction at this point in time.

### **6. The Country Legal Framework Profiles (available for download)**

Five country profiles covering the legal frameworks for China, Hong Kong, India, Japan and Singapore are available for download in PDF format. These were prepared on a pro bono basis by leading law firms based on a questionnaire designed by AVPN that addresses the key legal issues when establishing a VPO. The questionnaire uses the ecosystem framework and terminology described above that is consistent with the main section of the AVPN report “Getting Started in Venture Philanthropy in Asia”.

Each country profile is an overview and does not seek to address all the relevant legal, tax and regulatory issues in detail. New sponsors of a VPO should seek specific legal, tax and regulatory advice on the basis of their own circumstances before setting up their operating entity.

The reports are available for download from [www.avpn.asia/startVPO](http://www.avpn.asia/startVPO) .

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# LEGAL FRAMEWORK PROFILE for HONG KONG SAR

## AVPN Report - "Getting Started in Venture Philanthropy in Asia"

### Legal Framework Section

#### Hong Kong SAR Country Profile

This briefing paper for Hong Kong SAR has been prepared for AVPN by Mark Shipman, Karen Wong, Amy CK Lo and Bo Lai of Clifford Chance's Hong Kong Office. For more information please contact [Mark.Shipman@CliffordChance.com](mailto:Mark.Shipman@CliffordChance.com) (+852 2825 8992), [ChingKwan.Lo@CliffordChance.com](mailto:ChingKwan.Lo@CliffordChance.com) (+852 2825 8979) or [Bo.Lai@CliffordChance.com](mailto:Bo.Lai@CliffordChance.com) (+852 2826 3467). Descriptions and references to tax are for reference only. Each recipient of this paper should seek their own independent tax and legal advice from their appointed advisors.

#### 1. Introductory Comments

Charities in Hong Kong do not exist as a separate type of legal entity and most charities adopt the structure of a company limited by guarantee, with a small proportion of charities adopting the form of a society or a trust. As a general observation, the most common form of funding for charities in Hong Kong are donations and grants. Debt funding is uncommon. Equity funding is generally not applicable for charities, given the form of charities as a company limited by guarantee, society and trust, which does not have any share capital.

While charities do not exist as a separate type of legal entity, they are capable of acquiring a status of an 'Approved Charity' from the Inland Revenue Department ("IRD"). The main benefits of being an Approved Charity is the entitlement to exemption from profits tax in Hong Kong. Furthermore, donations made to an Approved Charity are tax deductible for donors who are taxpayers in Hong Kong for the amount of the donation (subject to a ceiling). To maintain the status of an Approved Charity, however, the activities of the entity must be for a solely charitable purpose. Engaging in activities deviating from such a purpose may cause its Approved Charity status to be lost. In the context of the proposed VPO models, this poses a fundamental difficulty to facilitate the flow of funds from an Approved Charity to a Business (whether as a form of funding to a Business SPO in the *VPO 'Non-Profit' Entity* model, or as a form of financial return to a Business VPO in the *VPO 'Commercial' Entity* model), as it would be difficult to justify the transfer of funds to a profit-driven commercial entity as being for a 'solely charitable purpose'.

It is worth noting that the Law Reform Commission of Hong Kong ("LRC") published a report on 6 December 2013 (the "**LRC Report**") following public consultation, recommending, among other things, that (a) all charitable organisations which (i) solicit from the public for the donation of cash or its equivalent from the public, and/or (ii) have sought tax exemption should be subject to the requirement of registration, (b) there should be a clear statutory definition of what constitutes a charitable purpose (the LRC also recommended that a number of specific heads should be included within the statutory definition), (c) the current system of allowing a variety of legal forms of charitable organisations to exist should continue, and (d) a set of specifically formulated financial reporting standard should be adopted for

charities.

As regards the other proposed models, as a general rule, where a Business is used for the VPO or SPO entity, the general company law and commercial law rules and requirements apply.

This paper has been prepared to provide a high-level summary of the major issues to consider when seeking to establish a VPO and/or SPO in Hong Kong, with reference to the questions raised in the AVPN Legal Framework Questionnaire. If further information on specific aspects of this paper is required, please let us know.

## 2. Country Scoping Questions

- (a) *Do "Social Enterprises" exist as a legal entity in your country, as opposed to charities (or their equivalent, e.g. NGOs) and traditional commercial entities (e.g. companies and businesses)?*

"Social enterprises" are not recognized as a separate type of legal entity in Hong Kong but generally exist in the form of companies or non-profit organisations. The Home Affairs Department of Hong Kong describes "social enterprises" as businesses that achieve specific social objectives such as, among other things, providing products or services needed by the community (such as support service for the elderly), creating employment and training opportunities for the socially disadvantaged, protecting the environment, or funding its other social services through the profits earned. Its profits will be principally reinvested in the business or the community for the social objectives that it pursues, rather than be distributed to its shareholders.<sup>1</sup>

- (b) *Is the relevant legislation and regulation of SPOs at the national government (i.e. federal) level or are there substantial State or other lower-tier laws and regulations (including tax) that apply?*

Not applicable.

## 3. Level One Questions

- (a) *List in the following table the relevant entities/structures of SPOs that exist in your country:*

 Relevant Charity Entities ("Charity")	 Relevant SE Entities [If applicable]	 Relevant Commercial Entities ("Business")
1. Company limited by guarantee	N/A	1. Company (limited by shares or limited by guarantee)
2. Society		2. Partnership
3. Trust		3. Sole proprietorship

<sup>1</sup> <http://www.social-enterprises.gov.hk/en/introduction/whatis.html>

- (b) *For each of the entities in 3(a) (or the most relevant if the list is extensive) please provide:*
- (i) *Brief description (definition) of the general legal nature of the entity/structure*
  - (ii) *The main considerations when seeking to establishing such an entity (e.g. time taken, regulatory approvals or filings needed, complexity of documentation, etc)*
  - (iii) *Main ongoing compliance requirements once established*
  - (iv) *Benefits / considerations for choosing such an SPO (including tax)*
  - (v) *Can the entity accept funding in the form of (i) donations/grants, (ii) debt, and (iii) equity ?*

### 3.1 **Relevant charity entities**

At present, there is no comprehensive legal framework for regulating charities in Hong Kong or statutory definition of what constitutes a charity. However, a regulatory regime for charities may be introduced in Hong Kong. Following public consultation, the LRC published the LRC Report on 6 December 2013 proposing the introduction of a comprehensive regulatory regime for charities in Hong Kong including, among other things, the introduction of relevant legislation and (although not at this time but as a long term goal) to set up a charity commission.

Among other things, the LRC Report recommended that (a) all charitable organisations which (i) solicit from the public for the donation of cash or its equivalent from the public, and/or (ii) have sought tax exemption should be subject to the requirement of registration, (b) there should be a clear statutory definition of what constitutes a charitable purpose (which should include a number of specific heads), (c) the current system of allowing a variety of legal forms of charitable organisations to exist should continue, and (d) a set of specifically formulated financial reporting standard should be adopted for charities. In relation to the recommendation to formulate specific financial reporting standards, it was recommended that:

- (a) filing requirements be imposed by Government bureaus/departments on charitable organisations in their applications for charitable fundraising licences or permits, such that:
  - (i) charitable organisations with an annual income exceeding \$500,000 (approximately US\$64,400) should be required to file an auditors' report and financial statements; and
  - (ii) without prejudice to the statutory requirements under the Companies Ordinance, registered charitable organisations with an annual income not exceeding HK\$500,000 (approximately US\$64,400) should be required to file financial statements certified by the board of these charitable organisations; and

- (b) tax-exempt charities should be required make information about their operations available to the public by publishing certain documents, such as their financial statements and activities' reports, on their websites.

Charities in Hong Kong are commonly established in one of the following forms:

- (a) a company limited by guarantee (i.e. a company without a share capital) incorporated under the Companies Ordinance (Cap. 622) ("**Companies Ordinance**");
- (b) a society registered under the Societies Ordinance (Cap. 151) ("**Societies Ordinance**"); or
- (c) a trust.

Charities may also be established in the form of a statutory body established by the Hong Kong legislature, an incorporated management committee established under the Education Ordinance (Cap. 279), an ad hoc special committee established for charitable purposes or an overseas company registered under Part 16 of the Companies Ordinance. These forms are not covered in this response as they are not common.

### 3.1.1 **Company limited by guarantee**

- (a) **Description.** The majority of charities and non-profit organisations (including trade, professional, business associations) in Hong Kong are established in the form of a company limited by guarantee rather than limited by shares, as no capital is required. A company limited by guarantee is required to maintain at all times:
  - (i) at least one member (the maximum number of members must be fixed);
  - (ii) at least two directors (a corporate director is not permitted);
  - (iii) a company secretary (who must be an individual ordinarily resident in Hong Kong or a company having its registered office or a place of business in Hong Kong); and
  - (iv) a registered office in Hong Kong.

Examples of Hong Kong charities in the form of a company limited by guarantee include Oxfam Hong Kong, Amnesty International Hong Kong Section Limited and Dialogue in the Dark (HK) Foundation Limited.

- (b) **Procedure.** To establish a company limited by guarantee, an application to establish a new company needs to be made by submitting an incorporation form (Form NNC1G), the articles of association ("**AoA**") of the company and a Notice to Business Registration Office (Form IRBR1) together with the relevant registration fee (HK\$170 (approximately US\$22) for 25 or fewer members, or a higher fee if more than 25 members) and business registration fee (up to approximately HK\$2,450 (approximately US\$316) for a one-year Business Registration Certificate) to the Companies Registry. It will take

approximately four weeks to process the application and issue the Certificate of Incorporation and Business Registration Certificate.

Subject to the approval of the Registrar of Companies, a company limited by guarantee can be incorporated without the word "Limited" in its company name, under section 103 of the Companies Ordinance. The processing time for this waiver can take as long as one year, as the Registrar needs to review the AoA of the company, consider the objects and charitable status of the company, assess the proposed activities and financial support of the company, and be satisfied that the company can attain its intended objects.

- (c) **Ongoing compliance requirements.** In general, the company has to hold an annual general meeting in accordance with its AoA, renew its Business Registration Certificate, submit an annual return regarding the company's particulars (for example, any change in the company name, change in the particulars of the secretary or any director, amendment to the AoA, the outstanding amount on all mortgages and charges and all special resolutions) to the Companies Registry, maintain full and proper books of account and prepare audited financial statements to be presented to shareholders at every annual general meeting.
- (d) **Benefits/considerations for choosing such an SPO.** According to the IRD statistics in December 2007, approximately 72% of charities in Hong Kong were in the form of a company, most of which were companies limited by guarantee.

The fundamental difference between a company and other structures is that a company is treated in law as a separate legal person. Accordingly, the law will treat a company as independent from the persons who make up the company. In the case of a company limited by guarantee, the liability of its members is limited to the amount that the members have agreed to contribute to the company's assets in the event of winding up, which is specified in the AoA and often of a nominal amount, e.g. HK\$100 (approximately US\$13). The members are not required to make monetary contribution to the company at the time of incorporation.

A company limited by guarantee that is an Approved Charity (as defined in section 3.1.5(a) *Charitable/tax exemption status of Approved Charities*) is entitled to tax exemption under section 88 of the Inland Revenue Ordinance (Cap. 112) ("**IRO**"). Please refer to section 3.1.5 *Charitable/tax exemption status of Approved Charities*.

- (e) **Forms of funding that can be accepted.** A company limited by guarantee can accept donations and grants. From an SPO's perspective, there are no restrictions on a company from receiving funding in the form of debt, however funding in the form of equity would not be applicable to a company limited by guarantee which does not have a share capital. Please note the tax implications on a donor who funds by debt or equity (see section 4 *Profits tax in Hong Kong*). Please also note the possible regulatory issues in respect of funding by debt (see section 5.1.2 *Financial regulatory restrictions*).

As described in section 1 *Introductory Comments*, it is generally uncommon for charities in Hong Kong to receive funding in forms other than donations and grants.

- (f) **Restriction on the payment of dividends and distribution of profits to non-members.** A company limited by guarantee may distribute realized profits among its members only. A company limited by guarantee that does not have a share capital is not allowed to provide any rights to persons who are not members to participate in the divisible profits of the company (section 99, Companies Ordinance). Any provision of the company's AoA or any resolution passed by the company that purports to divide the undertaking of the company into shares or interests is treated as a provision for a share capital although the nominal amount or number of the shares or interests is not specified (section 99, Companies Ordinance).

In any case, as discussed in section 3.1.5 *Charitable/tax exemption status of Approved Charities*, an Approved Charity is only permitted to apply profits for solely charitable purposes and its AoA should contain a clause prohibiting distribution of its incomes and properties amongst its members.

### 3.1.2 Society registered under the Societies Ordinance

- (a) **Description.** Less formal industry associations and social or recreational groups adopt the structure of a society. A society is an unincorporated association of a voluntary group of people (the members) bound together by a set of rules set out in its constitution. Examples of such associations are unincorporated members' clubs, unincorporated charitable institutions and voluntary associations for the purpose of carrying out functions of a social character. Two examples of charitable bodies registered as societies under the Societies Ordinance are The Samaritans and Hong Kong Blind Union.
- (b) **Procedure.** To establish a society under the Societies Ordinance, an application for registration or, where a society qualifies for an exemption from registration, an application for exemption from registration needs to be made to the Societies Officer of the Hong Kong Police Force under the Societies Ordinance (the "**Society Application**"). Charitable organisations which are societies may seek an exemption by establishing, to the satisfaction of the Societies Officer, that they are established solely for religious or charitable purposes. Not all charitable societies seek this exemption and remain registered under the Societies Ordinance (for example, the Samaritans and Hong Kong Blind Union), however the number of registered societies is small when compared to the total number of tax-exempt charities in Hong Kong. The Society Application will take approximately two weeks to process.

A society must have at least three office-bearers and a principal place of business in Hong Kong. Subject to certain restrictions, an existing society which is organised and has its headquarters or principal place of business outside of Hong Kong but nonetheless has an establishment in Hong Kong may be deemed to be established in Hong Kong for the purposes of the Societies Ordinance if any of its office-bearers or members resides or is present in Hong Kong.

- (c) **Ongoing compliance requirements.** There are no ongoing compliance requirements for societies. However, a society is required to notify the Societies Office of any change in the name, address, office-bearer(s) or objects of the society and in the event that the society is dissolved.

For societies registered under the Societies Ordinance, the Societies Officer may, at any time, by notice in writing require the society to provide such information as he may reasonably require for the performance of his functions under the Societies Ordinance. The information required may include the income, the source of income and expenditure of the society.

- (d) **Benefits/considerations for choosing such an SPO.** A society is free of the statutory controls which companies are subject to and is simple to set up and maintain. However, a society is an unincorporated body and is not a separate legal entity - therefore it cannot enter into contracts, sue or be sued in the society's name or on its behalf (except where such power has been expressly conferred by legislation) and it may encounter difficulties in identifying the persons with decision-making authority. Where work has been done for, or goods supplied to, a society, liability is determined by agency law. The only persons who can be made liable are those who gave the order for the work or the goods, or who either expressly or impliedly authorised the giving of the order on their behalf, or who ratified the order after it had been given. More importantly, members of the management committee and sometimes members of the society itself may be personally liable if the society's assets are not sufficient to meet its liabilities, as there is no limited liability attached to a society.

In order to qualify as a charitable unincorporated association, as distinct from other kinds of unincorporated associations, the objects of the association must be restricted to charitable purposes and its rules should contain a dissolution clause requiring surplus property to be used for charitable purposes rather than distributed among its members.

The main advantages of conducting a charity as a society are that its constitution can be tailored to suit an individual case, it is inexpensive to run and is free of statutory controls.

A society that is an Approved Charity is entitled to tax exemption under section 88 of the IRO. Please refer to section 3.1.5 *Charitable/tax exemption status of Approved Charities*.

- (e) **Forms of funding that can be accepted.** A society can accept donations and grants. The Societies Ordinance primarily deals with society registration issues and does not provide for restrictions on the funding of a society. Accordingly, whether debt funding can be accepted will depend on the society's objects and purposes as set out in its constitution. However, even if its constitution permits, there may be practical difficulties in entering into the relevant debt funding arrangement as a society is not a separate legal entity and there is potential unlimited liability on the person entering into the debt funding arrangement.

Please note the tax implications on a donor who funds by debt (see section 4 *Profits tax in Hong Kong*). Please also note the possible regulatory issues in

respect of funding by debt (see section 5.1.2 *Financial regulatory restrictions*).

Equity funding is not applicable for a society.

### 3.1.3 Trust

- (a) **Description.** A charitable trust is a trust formed for charitable purposes. It is usually set up by a group of persons, the trustees, who make a declaration of trust outlining the purposes of the trust. It may also be created by a settlor or testator who transfers or bequeaths funds or property to trustees upon trust for wholly and exclusively charitable purposes. The governing instrument of a charitable trust is the trust instrument (normally a trust deed) which sets out the purposes of the trust and the powers of the trustees. In addition to the content of the trust instrument, the legal rights, duties, obligations and discretionary powers of the trustees, together with limitations on their personal liabilities, may also be prescribed in common law and legislation.
- (b) **Procedure.** To establish a trust, the trust instrument must be drafted carefully to set out the operation of the trust as well as the powers of the trustee. In order to qualify as a valid charitable trust, as distinguished from a valid non-charitable trust, the trust must be created in language that is sufficient to show the settlor's intention and the subject matter of the gift must be capable of being ascertained. There must also be certainty that all potential objects are charitable. The Trustee Ordinance (Cap. 29) ("**Trustee Ordinance**") supplements and amends the relevant common law relating to trustees, including trustees' powers, the appointment and discharge of trustees and registration of trust companies. Most of the provisions in the Trustee Ordinance are non-mandatory provisions, which apply to trusts where the trust instrument is silent on a particular issue. With effect from 1 December 2013, trustees are subject to, among other things, a statutory duty of care under Part IA of the Trustee Ordinance unless specified otherwise in the trust instrument, however professional trustees (i.e., persons who are remunerated for acting as a trustee in a professional capacity) cannot exclude itself from liability for a breach of trust arising from the trustee's own fraud, wilful misconduct or gross negligence or grant the trustee any indemnity against trust property for such liability.
- (c) **Ongoing compliance requirements.** There are no documentary filing requirements in maintaining a trust, however trustees have the most intense form of fiduciary duties and, among other things, must keep an accurate account of the trust property and strictly conform to, and carry out the terms of, the trust, so far as they are for the time being in force.
- (d) **Benefits/considerations for choosing such an SPO.** Trusts are not a common form of charity in Hong Kong. Preparing the documentation to establish a trust is more time consuming and therefore costly, as it needs to be tailored for the intended purposes of the trust. In contrast, the constitutive documents of a company limited by guarantee, for example, are much more standardised. Even higher ongoing expenses would be incurred if a professional trust company is engaged to act as the trustee.

- (e) **Forms of funding that can be accepted.** Funding in the forms of donations, grants and debt can be accepted. Funding in the form of equity is not applicable for a trust. The capacity (or lack of capacity) of the trustees to accept debt funding (or enter into any other transaction) depends on the permitted purposes set out in the trust instrument, supplemented by the implied powers and purposes stipulated in the Trustee Ordinance. Where a trustee acts beyond the scope of the powers conferred to him as trustee by the trust instrument, common law or the Trustee Ordinance, the trustee would have acted in breach of the trust and the position at common law is that the trustee will be personally liable to any third party for all obligations contracted for on behalf of the trust, unless the trustee has expressly limited his personal liability in any contract entered into with such third party and provided that the trust instrument permits the trustee to limit his liability in such manner.

Any property or interest in property which a person can, at law or in equity, transfer or assign, or dispose of inter vivos (a transfer effected during the donor's lifetime) or by a testamentary instrument (a transfer that takes effect on the death of the donor), can be affected by him with a trust by an instrument inter vivos or by a testamentary instrument.

There must also be certainty as regards the property and the objects of the trust so that the trust is administratively operable. Regarding the requirement of certainty as to trust property, both tangible and intangible assets are capable of satisfying the requirement of certainty. In the case of shares, it is not necessary to consider segregation or appropriation as a means of identifying the goods, so long as the quantity of the shares which are to form the subject matter of the trust are known. Funders can make a declaration to the effect that specific property, such as an amount of money, money in a specified account (for example, an account to which donations are made) or a specified number of shares, is to be held by the trustees in trust for the specified charitable objects of the trust.

- (f) **Registered Trustees Incorporation Ordinance (Cap. 306) ("RTIO").** The purpose of the RTIO, as described in the long title of the legislation, is to "facilitate the incorporation of trustees appointed by certain bodies, associations and communities of persons, and of trustees of charities and to make provision for purposes connected therewith."

Duly appointed trustees of any body of persons or charity may apply to the Registrar of Companies for a certificate of incorporation (section 3, RTIO). Under the RTIO, "charity" is defined as any trust or organisation established by deed or otherwise for a charitable purpose (section 2, RTIO). The trustees and their successors will be a body corporate by the name specified in the certificate which may sue and be sued (section 4(2), RTIO), and a register of all such registered trustee corporations is maintained by the Registrar of Companies which is open for public inspection. It should be noted that the incorporation of a trustee does not negate its potential liability for breaches of trust. All trustees constituting the registered corporation can be charged for the trust property coming into their hands, and are answerable and accountable for their own acts, receipts, act of neglect, and default, and for the due administration of the trusts and trust property in the same manner and to the same extent as if the incorporation had not been effected (section 11, RTIO).

### 3.1.4 Foundations

There are no specific legislation, rules or exemptions applicable to "foundations".

### 3.1.5 Charitable/tax exemption status of Approved Charities

- (a) **Overview.** An entity recognised by the IRD as a charitable institution or trust of a public character ("**Approved Charity**") is entitled to tax exemption under section 88 of the IRO. An application must be made to the IRD for recognition as an approved charitable institution or a trust of a public character under the IRO (see section 3.1.5(b) *Charitable/tax exemption status of Approved Charities*).

An Approved Charity must be established for public benefit and for purposes which are exclusively charitable. Charitable purposes are classified into four heads in the "Tax Guide for Charitable Institutions and Trusts of a Public Character" issued by the IRD:

- (i) relief of poverty;
- (ii) advancement of education;
- (iii) advancement of religion; and
- (iv) other purposes of a charitable nature beneficial to the Hong Kong community.

Whilst the purposes prescribed in heads (i), (ii) and (iii) above may be in relation to activities carried on in any part of the world, the purposes prescribed in (iv) above will only be regarded as charitable if they are of benefit to the Hong Kong community.

The current common law position on what may constitute a "charitable purpose" is that the purpose must fall either within one of the four categories of charitable purposes set out in (i) to (iv) above, or for one of the following purposes (derived from the preamble to the Charitable Uses Act 1601 in England):

"The relief of aged, impotent and poor people; the maintenance of sick and maimed soldiers and mariners, schools of learning, free schools and scholars in universities; the repair of bridges, ports, havens, causeways, churches, sea-banks and highways; the education and preferment of orphans; the relief, stock or maintenance of houses of correction; the marriages of poor maids, the supportation, aid and help of young tradesmen, handicraftsmen, and persons decayed; the relief or redemption of prisoners or captives; and the aid or ease of any poor inhabitants concerning payment of fifteens, setting out of soldiers and other taxes."<sup>2</sup>

Examples of purposes which have been identified in the courts as not being "charitable" in the legal sense include those which are political in nature, those which promote the benefits of the founders or subscribers of the organisation, those which

<sup>2</sup> As set out in *Hong Kong & Shanghai Bank Hong Kong (Trustee) Ltd v The Incorporated Trustee of the Islamic Community Fund of Hong Kong & Others* [1984] 1 HKC 152, at 156 (HCt), per Rhind J, referring to Picarda, *The Law and Practice Relating to Charities* (Butterworths, 1999), at 8.

encourage a particular sport (as opposed to sports generally) and those for the provision of a playing field, recreation ground or scholarship fund for employees of a particular company or industry.

The purpose must also be "for the public benefit". There is a presumption in common law that the purpose is for the public benefit until the contrary is proven for heads (i), (ii) and (iii) of charitable purpose above. A charitable purpose falling under head (iv) above must be both beneficial and available to a sufficient section of the Hong Kong community.

(b) **Major tax advantages.** An Approved Charity enjoys the following tax advantages under ordinances administered by the Commissioner of Inland Revenue:

(i) Exemption from profits tax under the IRO: section 88 of the IRO provides that an Approved Charity is exempt from tax under the IRO. A proviso to section 88 states that for the purpose of profits tax, if an Approved Charity carries on a trade or business, the profits from such trade or business are exempted only if:-

(1) the profits are applied solely for charitable purposes, and

(2) the profits are not expended substantially outside Hong Kong, and

(3) either-

- the trade or business is exercised in the course of the actual carrying out of the expressed objects of the institution or trust (for example, a religious body might sell religious tracts); or
- the work in connection with the trade or business is mainly carried on by persons for whose benefit such institution or trust is established (for example, a society for the protection of the blind might arrange for the sale of handicraft work made by the blind).

A tax exemption will only be given to charities subject to the jurisdiction of the courts in Hong Kong, i.e., charities established in Hong Kong or Hong Kong establishment of overseas charities such as those deemed to be established in Hong Kong under section 4 of the Societies Ordinance or registered under Part 16 of the Companies Ordinance (i.e. companies incorporated outside Hong Kong establishing a place of business in Hong Kong).

The IRD will review the exemption status of an Approved Charity by requiring it to submit its books and accounts for review every three to four years so as to ensure that the organisation is still charitable and its activities are compatible with its objects. There is no statutory requirement for an Approved Charity to submit annual reports to the IRD.

(ii) Stamp Duty Ordinance (Cap. 117) ("SDO"): stamp duty shall not be chargeable on any conveyance of Hong Kong real property or any transfer of Hong Kong shares, where the beneficial interest therein is passed *by way of gift* from the donor (whether the donor is the person entitled to, or the

registered owner of that interest) to or on trust for an Approved Charity (Head 1(1), (1AA) or 2(3) under Schedule 1 of the SDO).

- (iii) Business Registration Ordinance (Cap. 310) ("BRO"): charitable, ecclesiastical or educational institutions of a public character are normally exempt from the obligation of business registration unless a trade or business is carried on. Where such an institution carries on a trade or business, the exemption will only be granted if the conditions set out in section 16(a) of the BRO are satisfied. These conditions are similar to the conditions set out in the proviso to section 88 of the IRO as explained in the sub-paragraph (i) above.

- (c) **Tax deduction for donors with income arising in or derived from Hong Kong.** Charitable donations of money *by way of gift* to Approved Charities, in total of not less than HK\$100 (approximately US\$13), are allowable for deduction in computing the assessable profits of donors who are required to pay tax in Hong Kong (which includes any person (individuals or companies) with income that arises in or is derived from Hong Kong), subject to a current ceiling of 35% of the donor's adjusted assessable profits. To qualify as a donation, which in ordinary sense means a gift, it was held in *Sanford Yung – Tao Yung v Commission of Inland Revenue (HKTC 1081)* that the property transferred must be transferred voluntarily and not as a result of a contractual obligation to transfer it and *no advantage of a material character is received by the transferor by way of return*.

However, this tax deduction is not available if a donor provides funding to an SPO by way of equity or debt.

### 3.1.6 **Application for recognition as an Approved Charity**

Application to the IRD for recognition as an Approved Charity can be made before or after the organisation is established. However, the tax exemption available to an Approved Charity will only be available once it is recognised as an Approved Charity. The relief will not apply retrospectively.

An organisation applying to be recognised as an Approved Charity must submit its constitutive documents, i.e. the AoA for a company limited by guarantee, constitution for a society, or trust deed for a trust (in draft form if the organisation has not been established), an activities plan for the next 12 months together with the application letter to the Charitable Donations & Retirement Schemes Section of the IRD (the "**IRD Application**").

The constitutive documents of the organisation should generally contain provisions that:

- (a) state clearly the objects of the organisation;
- (b) limit the application of its funds towards the attainment of its stated objects;
- (c) prohibit distribution of its income and properties amongst its members;
- (d) prohibit members of its governing body from receiving remuneration;
- (e) specify how the assets should be dealt with upon its dissolution (the remaining assets should normally be donated to other charities);

- (f) require it to keep sufficient records of income and expenditure (including donation receipts), proper accounting books and compilation of annual statements; and
- (g) exclude the powers set forth in the Seventh Schedule to the Companies Ordinance (in case of a company limited by guarantee).

The IRD Application will take approximately six to eight weeks to process. More time may be required if the IRD has comments on the constitutive documents submitted as the applicant will need to liaise with the IRD to amend its constitutive documents into a form which is satisfactory to the IRD. It is therefore recommended that the IRD Application be submitted before the organisation is established as the IRD's comments would need to be incorporated into the constitutive documents.

### 3.1.7 **Non-profit organisation**

In Hong Kong, not all non-profit organisations are regarded as charities, irrespective of the worthiness of their causes of being and functioning. The IRO does not have any provision of tax exemption for non-profit organisations. Only non-profit organisations that qualify for recognition as an Approved Charity pursuant to section 88 of the IRO are entitled to tax exemption status in Hong Kong.

## 3.2 **Relevant commercial entities**

### 3.2.1 **Company**

- (a) **Description.** A limited company is a company that is incorporated or registered in accordance with the Companies Ordinance. The liabilities of the shareholders of a limited company can be either:
  - (i) limited to the amount of shares held by them (limited by shares), or
  - (ii) limited to the amount that the shareholders have agreed to contribute to the company's assets if the company is wound up (limited by guarantee).

It is not common for business organisations that intend to distribute profits to be established as companies limited by guarantee.

For information regarding a company limited by guarantee, please refer to section 3.1.1 *Company limited by guarantee*.

A company limited by shares has a separate legal status and is able to enter into contracts, sue or be sued, own property and borrow money in its own name. A private limited company cannot offer shares to the public at large, but must have at least one shareholder and may have up to 50 shareholders whose right to transfer shares is limited, and must have at least one director (sections 67(1), 11 and 454, Companies Ordinance). The company's AoA will set out details of the limitations of power and the rules that govern the company. A model AoA can be found in Schedule 2 (AoA for a private company limited by shares) to the Companies Ordinance ("**Model Articles**"). It would also be prudent to prepare a shareholders' agreement that covers the mechanisms for

the disposal or transmission of shares, the resolution of managerial and policy disputes and the protection of interests of minority shareholders.

- (b) **Procedure.** To establish a company limited by shares, the AoA, incorporation form (Form NNC1) and Notice to Business Registration Office (IRBR1) are required to be submitted to the Companies Registry together with the relevant registration fees for the registration of the company (approximately HK\$1,720 (approximately US\$222) and business registration fee (up to approximately HK\$2,450 (approximately US\$316) for a one-year Business Registration Certificate). The Companies Registry will take approximately four working days to process the application. A Certificate of Incorporation and a Business Registration Certificate will be issued. The company will then need to submit Form IRC200 to notify the IRD in writing of the relevant business particulars after they commence their business.

The BRO requires every person who carries on a business in Hong Kong to apply for business registration within one month from the date of commencement of the business, and to display a valid Business Registration Certificate at the place of business.

- (c) **Ongoing compliance requirements.** In general, the company has to hold an annual general meeting in accordance with its AoA, renew its Business Registration Certificate, submit an annual return and relevant forms regarding the change of the company's particulars (e.g. resignation of auditor, change in the name of the company, change in the particulars of the secretary or any director, mortgage or charge details, amendments to articles of association, allotment of shares, change in the share capital structure, change in directors and secretary and all special resolutions) to the Companies Registry, maintain full and proper books of account and prepare audited financial statements to be presented to shareholders at every annual general meeting.

A private company must ensure that it maintains at all times at least one shareholder and not more than 50 shareholders, at least one director (at least one of which must be a natural person), a company secretary, a registered office in Hong Kong and keep statutory records including registers, minutes of meetings and copies of duly filed documents with government bodies in Hong Kong. A limited company must also maintain full and proper books of account and prepare audited financial statements annually and present such accounts to shareholders at every annual general meeting, as well as prepare tax returns to the IRD.

- (d) **Benefits/considerations for choosing such an SPO.** The major advantage of establishing a SPO in the form of a company is that the shareholders' liability for the company's debts is limited to the amount of their respective contribution to the share capital of the company. In addition, it is easy to transfer the interests of the business by transferring shares to existing or new shareholders without interfering with the corporate structure (provided that the approval of the company is obtained and the relevant rules and procedures set out in the company's AoA are complied with).

However, shareholders cannot withdraw their capital at will from the company (unless they sell their shares to others) and certain information in respect of

the company (e.g. the company's AoA, details of shareholders, directors, company secretary and debenture holders, number and class of shares issued and total indebtedness in respect of all mortgages and charges) is publicly available through the register of the Companies Registry.

- (e) **Tax.** Every person who carries on a trade, profession or business in Hong Kong will be subject to profits tax in respect of assessable profits from that trade, profession or business arising in or derived from Hong Kong (other than gains on the sale of capital assets). Only Hong Kong source income is taxed and liability to Hong Kong tax is not dependent on a person's residence in Hong Kong (residence is, however, relevant in some circumstances). Offshore income is generally not subject to tax in Hong Kong. Please see section 4 *Profits tax in Hong Kong*.

The current profits tax rate (for financial year 2013/14) for corporations is 16.5% on the assessable profits for each year of assessment.

- (f) **Forms of funding that can be accepted.** A company limited by shares can, accept funding in the form of donations, grants, debt and equity, provided that such forms of funding is permitted under the company's AoA. The board of directors of the company may exercise the borrowing powers conferred to them under the company's AoA. Please note the possible regulatory issues in respect of funding by debt (see section 5.1.2 *Financial regulatory restrictions*).

### 3.2.2 Partnership

- (a) **Description.** A partnership is the relation which subsists between persons carrying on a business in common with a view of profit. The law relating to partnership is codified under the Partnership Ordinance (Cap. 38) and the Limited Partnerships Ordinance (Cap. 37).

In a partnership, unlike a limited company, each partner in a partnership is personally jointly and severally liable for the acts of the other partners and for all of the debts and obligations of the partnership, and accordingly assumes unlimited liability for the partnership. Conversely, all partners are entitled to share the right to use partnership property and to share the profits of the partnership equally, unless they agree otherwise.

In the case of a limited partnership, there is one or more general partner(s) and one or more limited partner(s). A general partner has the same rights and obligations as in a general partnership described above, including the authority to dispose of assets held in a limited partnership's account, assume unlimited liability for the limited partnership, etc. A limited partner has no management control and his liability is limited to the amounts which he has agreed to contribute to the partnership. If a limited partner participates in the management of the partnership business, he will be liable for all debts and obligations of the firm incurred while he so takes part in the management as though he were a general partner. The general partner(s) would pay the limited partner(s) a return on their investment (similar to a dividend), the nature and extent of which is usually defined in the limited partnership agreement.

Neither a partnership nor a limited partnership has an independent legal existence.

- (b) **Procedure.** To establish a partnership or a limited partnership, an application for registration of the business (Form 1(c)) needs to be submitted to the Business Registration Office together with the business registration fee (up to approximately HK\$2,450 (approximately US\$316) for a one-year Business Registration Certificate) within one month of the commencement of the business. The form requires basic information, such as the name of the entity, business address and nature of the business to be provided. If the content of the forms are in order, the Business Registration Office will be able to immediately issue the Business Registration Certificate.

For a limited partnership, an additional application for registration of the limited partnership (Form 1) needs to be submitted to the Companies Registry together with the applicable registration fees. A Certificate of Registration of a Limited Partnership is normally issued in five working days.

It is also important for the partners to prepare a partnership agreement or limited partnership agreement (as the case may be) that contains provisions for profit sharing, control and the settling of managerial and policy disputes.

- (c) **Ongoing compliance requirements.** A partnership and a limited partnership must notify the Business Registration Office of any change in the registered particulars provided in Form 1(c) described in paragraph (b) above and renew the Business Registration Certificate. In addition, it is advisable for a partnership or limited partnership to prepare audited accounts annually, for the purposes of submitting their tax return to the IRD.

A limited partnership must also notify the Companies Registry within seven days of any change in the registered particulars contained in Form 1 described in paragraph (b) above, including, among other things, any change in the partners or name of any partner, change in the term of character of the partnership, change in the sum contributed by any limited partner or total amount contributed by any new limited partner, or change in the liability of any partner by reason of his becoming a limited instead of a general partner (or vice versa). Documents filed to the Companies Registry are available for public inspection upon the payment of a small fee.

- (d) **Benefits/considerations for choosing such an SPO.** Partners in both a partnership and limited partnership are not subject to the restrictions that companies are under the Companies Ordinance, and enjoy much more flexibility in operating the firm. The provisions of the Partnership Ordinance apply, generally, only if a matter has not been provided for in the partnership agreement. However, partners in a partnership and general partners in a limited partnership do not have the benefit of limited liability.

Partnerships are tax-transparent. Partners of both a partnership and limited partnership pay tax on their share of partnership profits at the partner's relevant tax rate. Partners who are corporates are taxed at the profits tax rate for incorporated businesses of 16.5%; individual partners are taxed at the profits tax rate of unincorporated businesses of 15%.

For partners of a partnership, losses are allocated to each partner and where the partner is an individual he may elect for personal assessment and set off his share of the loss against other sources of assessable income, or he can carry the loss forward and set it off against his share of any future profits of the partnership.

Where the partner is a corporation, its shares of the losses of a partnership can be set off against assessable profits from other sources and to the extent not so set off, can be carried forward and be set off first against the corporation's share of any future assessable profits of the partnership and then against any other future assessable profits of the corporation.

For partners of a limited partnership, the utilization of losses by the limited partners is more restricted than a partner in a general partnership.

- (e) **Forms of funding that can be accepted.** Neither the Partnership Ordinance nor the Limited Partnership Ordinance restricts the sources of funding that may be accepted by a partnership or limited partnership. Therefore, except for equity funding which is not applicable for a partnership structure, a partnership may accept funding in the form of donations, grants or debt unless otherwise restricted under the partnership agreement or the limited partnership agreement (as the case may be). Please note the possible regulatory issues in respect of funding by debt as discussed (see section 5.1.2 *Financial regulatory restrictions*).

### 3.2.3 Sole proprietorship

- (a) **Description.** A sole proprietorship is a business that is run by a single individual. The owner of a sole proprietorship is personally entitled to all the profits and is responsible for all the liabilities arising from the business. Sole proprietorships are required to be registered under the provisions of the BRO. A sole proprietorship does not have an independent legal existence.
- (b) **Procedure.** To establish a sole proprietorship, an application for registration of the business (Form 1(a)) needs to be submitted to the Business Registration Office together with the business registration fee (up to approximately HK\$2,450 (approximately US\$316) for a one-year Business Registration Certificate) to register the business, within one month of commencement of business. The form requires basic information, such as the name of the entity, business address and nature of the business. If the content of the forms are in order, the Business Registration Office will be able to issue the Business Registration Certificate immediately.
- (c) **Ongoing compliance requirements.** There are no other ongoing compliance requirements, except for the renewal of the Business Registration Certificate, filing of the sole proprietor's profits tax return to the IRD and the notification of any change in the registered particulars described in paragraph (b) above to the Business Registration Office within one month of the change(s).
- (d) **Benefits/considerations for choosing such an SPO.** A sole proprietorship is the simplest and most flexible business structure and the sole proprietor has absolute control as regards the policies, profits and capital investment of the business. Profits from the business will be taxed at the profits tax rate for

unincorporated businesses of 15%. Profits from such business may be subject to the individual's marginal tax rate if the individual has elected for personal assessment for the accounting year in which the trading profits accrue. Losses made from the business in an accounting year are to be carried forward and set off against future profits of the business. An individual who incurs a trading loss and who has claimed personal assessment will have the loss allowed as a deduction from his total income.

However, the sole proprietor has unlimited personal liability for all liabilities of the business which may result in personal bankruptcy, and the sole proprietor may not be able to raise additional capital from outside sources to expand the business.

- (e) **Forms of funding that can be accepted.** Except for equity funding which is not applicable for a sole proprietorship as there is no share capital, there are no restrictions on a sole proprietorship accepting funding in the form of donations, grants and debt. Please note the possible regulatory issues in respect of funding by debt (see section 5.1.2 *Financial regulatory restrictions*).

#### 4. Profits tax in Hong Kong

Persons, including corporations, partnerships, trustees and bodies of persons carrying on any trade, profession or business in Hong Kong are subject to tax on all profits (excluding profits arising from the sale of capital assets) arising in, or derived from, Hong Kong from such trade, profession or business. To determine whether income has its source within Hong Kong the test to be applied is, in general, whether the operations to be performed in order to earn the income were performed in Hong Kong and whether the central management and control of the entity was situated in Hong Kong. There is no distinction made between residents and non-residents.

The profits tax rate for the financial year 2013/2014 is currently 16.5% of the assessable profits of corporations and 15% of the assessable profits of unincorporated businesses such as sole proprietorships and partnerships.

- (a) Interest on loans. In general, all expenses, to the extent that they have been incurred by the taxpayer in the production of chargeable profits, are allowed as deductions (section 16, IRO). Accordingly, interest expense paid on debt by a borrower-taxpayer (e.g. a VPO that has received debt funding from a Funder, or a SPO that has received debt funding from a VPO) who has used the debt for the purpose of producing chargeable profits are tax deductible for the borrower-taxpayer. On the other hand, interest income received by a lender-taxpayer (e.g. a Funder that has provided debt funding to a VPO, or a VPO that has provided debt funding to a SPO) will be subject to profits tax at the applicable profits tax rate.
- (b) Dividends. Where a taxpayer has provided equity funding to an entity and receives dividend income, the dividends received are excluded from the assessable profits of the recipient taxpayer and are not subject to tax (section 26, IRO). The dividend payment from the dividend paying entity is not a deductible expense for computing the entity's profits.

## 5. Level Two Questions

- (a) *For the three VPO operating models please list the most relevant option choices for entities:*

No Fund Entity "circle" or "club"  [In this case an entity is only for the VPO consulting function]	VPO "non-profit" entity    Relevant SE and/or C Entities	VPO "commercial" entity   Relevant Commercial Entities
An adviser in a VPO listed in columns 2 and 3 could provide consultancy services to Funders in Level 3.	1. Company limited by guarantee	1. Company (most commonly a company limited by shares)
	2. Society	2. Limited partnership
	3. Trust	3. Fund (established as a company or a limited partnership)

The discussion on the different structures of charitable entities and commercial entities for the SPO also applies to the choice of structure for the VPO.

- (b) *Outline the benefits or considerations for each option as a choice for a VPO*

*Specifically for each VPO business model and entity:*

- (i) *Can the entity distribute financial returns to its stakeholders in the form of grant/donation refunds, debt principal repayment and interest payments, equity dividends and buy-backs.*
- (ii) *If a commercial entity is used, do financial regulatory restrictions apply (e.g. for fund raising or fund management)? How can these be avoided? (e.g. private entity, limited solicitation)*

### 5.1 VPO "No fund" entity model

- 5.1.1 **Benefits or considerations as a choice for a VPO.** This is the simplest model, pursuant to which there is no intermediate VPO entity and the funding will flow directly from the Funder to the SPO.

The discussion on the funding options available to Approved Charities and commercial entities in sections 3.1 *Relevant charity entities* and 3.2 *Relevant commercial entities* also applies to the funding between a Funder at Level 3 and a SPO at Level 1.

Persons with venture philanthropy experience may act as advisers and provide consultancy services to a Funder at Level 3.

- 5.1.2 **Financial regulatory restrictions.** Under the Money Lenders Ordinance (Cap. 163) ("MLO"), any person that carries on business as a "money lender" must be licensed under the MLO unless an exemption is available. It is an offence under the MLO to carry on business as a money lender without a licence granted or an exemption under the MLO. Funders providing funding to the VPO through debt may therefore trigger the requirements of the MLO as the Funder may be deemed to be carrying on a business as a "money lender".

A "money lender" means every person whose business (whether or not he carries on any other business) is that of making loans or who advertises or announces himself or holds himself out in any way as carrying on that business, but does not include certain exempted persons (specified in Part 1 of Schedule 1 of the MLO) and persons making certain exempted loans (specified in Part 2 of Schedule 1 of the MLO). A "loan" is defined in the MLO as including an advance, discount, money paid for or on account of or on behalf of or at the request of any person, or the forbearance to require payment of money owing on any account whatsoever, and every agreement (whatever its terms or form may be) which is in substance or effect a loan of money, and also an agreement to secure the repayment of any such loan.

Exempted loans specified in Part 2 of Schedule 1 to the MLO include, but are not limited to: (a) a loan made by a company, firm or individual whose ordinary business *does not primarily or mainly involve the lending of money*, in the ordinary course of that business; and (b) a loan made to a company that has a paid up share capital of not less than HK\$1,000,000 (approximately US\$130,000) or an equivalent amount in another approved currency.

While each case will need to be determined on its own fact, in a proposed venture philanthropy model in which a Funder generally provides funding by way of debt and expects repayment and/or a financial return, there is a possibility that such Funder may be deemed to be a "money lender". Such Funder may need to obtain licence under the MLO unless an exemption applies.

- 5.1.3 **Form of distributing financial returns to its stakeholders.** As there is no VPO entity at Level 2 in this model, it is relevant to consider the returns which may flow directly from a SPO at Level 1 to a Funder at Level 3. As discussed in section 3.1.5 *Charitable/tax exemption status of Approved Charities*, the constitutive documents of an Approved Charity should prohibit the distribution of its income and properties amongst its members. We are, therefore, of a view that financial returns to a Funder at Level 3 would not be permissible.

- 5.1.4 **Tax considerations.**

- (a) Approved Charity as a SPO at Level 1: a Funder who has made profits derived or arising from a Hong Kong source can claim a tax deduction on the amount of donation to the Approved Charity, of up to 35% of the Funder's assessable profits. As described in section 3.1.5 *Charitable/tax exemption status of Approved Charities*, an Approved Charity can only apply its profits for charitable purposes and therefore would not be permitted to remit any funds to a Funder as financial return. Further, where a Funder at Level 3 expects financial returns through their funding to a SPO, such funding may not qualify as donation as discussed in section 3.1.5 *Charitable/tax exemption status of Approved Charities* and so would not be tax deductible.

- (b) Commercial entity as a SPO at Level 1: a Funder will not be entitled to any tax deduction for a donation to a Business as tax deduction is only available to donations to an Approved Charity. Please refer to section 4 *Profits tax in Hong Kong*.

!

## 5.2 VPO "Non-profit" entity model

- 5.2.1 **Benefits or considerations as a choice for a VPO.** The benefits and considerations of the different structures that may be adopted by charitable entities and commercial entities as a choice for a SPO discussed in sections 3.1 *Relevant charity entities* and 3.2 *Relevant commercial entities* also apply when considering the structure to be adopted for a VPO.

### 5.2.2 Financial regulatory restrictions.

An Approved Charity that is a VPO at Level 2 or SPO at Level 1 may receive funding from the level above in the form of a donation, grant or debt. Generally speaking, equity funding is not suitable for Approved Charities as most Approved Charities are established in the form of a company limited by guarantee, which does not have equity available for subscription by the Funder. Please see section 3.1 *Relevant charity entities* for a discussion on the forms of funding available to an Approved Charity.

A Business that is a SPO at Level 1 may receive funding in the form of a donation, grant, debt or equity (see sections 3.2.1(f) *Company*, 3.2.2(e) *Partnership* and 3.2.3(e) *Sole proprietorship* for a discussion on the forms of funding available to the various types of commercial entities). However, it is questionable whether an Approved Charity VPO would be permitted to provide funding to a Business SPO at all, in light of the "solely charitable purpose" restriction on an Approved Charity's activities which is unlikely to accommodate the commercial nature of a Business SPO.

There are no financial regulatory restrictions on donations and grants, however financial regulatory restrictions may apply in respect of funding in the form of debt or equity. Debt or equity funding in the form of shares or debentures are subject to the offering restrictions under both the Companies Ordinance and the Securities and Futures Ordinance (Cap. 571) (the "**SFO**"), while funding in the form of other types of "securities" (defined in section 5.3.5(a)(iii) *Restrictions under the SFO*) are subject only to the SFO. Please refer to the discussion on the potential regulatory issues of offering shares, debentures and securities under the Companies Ordinance and/or the SFO (as applicable) in section 5.3.5 *Financial regulatory restrictions*. In relation to debt funding, please refer to the discussion on the potential regulatory issue of money lending in section 5.1.2 *Financial regulatory restrictions*.

### 5.2.3 Form of distributing financial returns to its stakeholders.

- (a) From a VPO at Level 2 to a Funder at Level 3: Not applicable, as a VPO "non-profit" entity model assumes that only social return will flow from Level 2 to Level 3.
- (b) From a SPO at Level 1 to a VPO at Level 2:!Where an Approved Charity VPO funds an Approved Charity SPO by way of a donation, it would be possible for the Approved Charity SPO to provide financial return to the Approved Charity

VPO in the form of a donation, *provided that* the Approved Charity VPO and the Approved Charity SPO share the same charitable purpose(s) so that in making such a donation, the Approved Charity SPO is acting in accordance with its specified charitable purpose(s). Such "financial return" would, in practice, simply be a separate donation that is unrelated to the initial donation received by the Approved Charity SPO (as mentioned in section 3.1.5(c) *Tax deduction for donors with income arising in or derived from Hong Kong*, the property transferred must be transferred voluntarily and not as a result of a contractual obligation, and no advantage of a material character is received by the transferor by way of return).

In the case of a Business SPO, it would also be possible for it to provide a financial return to the Approved Charity VPO in the form of a donation or grant.

Please refer to section 3.1.5 *Charitable/tax exemption status of Approved Charities*.

#### 5.2.4 Tax considerations in the model.

- (a) A Funder (Level 3) providing funding to an Approved Charity VPO (Level 2): Funding (in the form of donation or grant) provided to an Approved Charity VPO will be tax deductible for an amount up to 35% of the Funder's assessable profits, if the Funder is a taxpayer in Hong Kong. Please refer to section 3.1.5 *Charitable/tax exemption status of Approved Charities*.
- (b) Approved Charity VPO (Level 2) providing funding to Approved Charity SPO (Level 1): This funding arrangement will be tax exempt.
- (c) Approved Charity VPO (Level 2) providing funding to Commercial Entity SPO (Level 1): To be recognised as an Approved Charity, the charity must be established for purposes which are exclusively charitable according to law (please refer to section 3.1.5 *Charitable/tax exemption status of Approved Charities*). Depending on the objects of the Approved Charity as described in its constitutive documents, providing financial support to a Business may or may not be consistent with its objects. A Business is ultimately profit-driven, and making a social impact is in most cases a subsidiary objective, such that injecting funds (i.e., in the form of a donation or grant) into a business, including one that has a social purpose, would not be considered by the IRD to be for a solely charitable purpose. It is possible that a particular business is significantly incidental to an Approved Charity's charitable purpose so that providing financial support to the business is indeed consistent with Approved Charity's objects, however this will need to be considered on a case-by-case basis.

Considering the risk of the Approved Charity losing its tax exempt status, this arrangement is not advisable.

#### 5.3 VPO "Commercial" entity model

The Funders at Level 3 expect financial return from the VPO in the VPO "Commercial" entity model by way of (i) return of capital from the VPO or (ii) return

of capital from the VPO plus a return at a benchmark rate. This is the key difference from the model as set out in section 5.2 *VPO "Non-profit" entity model*.

- 5.3.1 **Benefits or considerations as a choice for a VPO.** Funding by way of a donation or grant is essentially a gift to the recipient, and therefore the expectation of financial return would be inconsistent with the donor's intention of making a donation.

As discussed above in section 5.1.2 *Financial regulatory restrictions*, funding by way of debt may trigger money lenders' issues unless such loan falls under the definition of "exempted loan" or the lender is an "exempted person", and funding by way of debt or equity in the form of shares, debentures or "securities" may trigger the offering restrictions under the Companies Ordinance and/or the SFO (as applicable) unless the offer falls within a safe harbour. Please refer to sections 5.1.2 *Financial regulatory restrictions* and 5.3.5 *Financial regulatory restrictions*.

The discussion on commercial entities in section 3.2 *Relevant commercial entities* also applies to the choice of structure for a VPO. The choice of establishing a VPO as a private company limited by shares and as a limited partnership is discussed below.

Further, as discussed above in section 3.1.1(f) *Restriction on the payment of dividends and distribution of profits to non-members*, an Approved Charity will not be permitted to make distribution of income or properties to its member and therefore it would not be possible for an Approved Charity in Hong Kong to provide financial returns to its members, donor or funders.

Our discussion below will therefore assume that the SPO at Level 1 is a Business which is not an Approved Charity.

The VPO will essentially be a fund which pools the funding from the Funders at Level 3 and will in turn allocate such funding to the underlying SPOs at Level 1.

- 5.3.2 **VPO as a private company limited by shares.** Where the VPO is established as a company limited by shares, the Funders can become shareholders of the company and fund the desired philanthropic activities through contributions to the share capital of the company. Persons with venture philanthropy experience can be the directors who will be responsible for the screening and selection of the SPOs and making decisions as to when to fund and exit such SPOs.
- 5.3.3 **VPO as a limited partnership.** Where the VPO is established as a limited partnership, the Funders will bring funds into the VPO as limited partners. The general partner, which assumes unlimited liability and is responsible for the day-to-day management of the limited partnership while owing fiduciary duties to the limited partners (please refer to section 3.2.2(a) *Partnership*). A general partner is usually a company incorporated with limited liability and the limited partnership will be managed by persons with venture philanthropy experience.
- 5.3.4 **Form of distributing financial returns to its stakeholders.**
- (a) Company
- (i) *Distribution of profits*: Under Part 6 of the Companies Ordinance, a company may only make a distribution of its assets (in cash or otherwise) to its members out of profits available for distribution, subject to specified exceptions (for example, distributions to its members by way of bonus shares or on the winding up of the company) (section 297, Companies Ordinance).

This restriction is to ensure that shareholders receive profit as distinct from the capital of the company, which is generally regarded as the fund relied on by the creditors.

A company's "distributable profits" are essentially its accumulated, realised profits less its accumulated, realised losses in a particular financial year. A company wanting to make a distribution cannot simply look at its current financial position, but must also take any previous trading losses into consideration. Additional rules apply to listed companies. A distribution which is in breach of section 297 of the Companies Ordinance is unlawful and without effect.

In addition, further restrictions on the sums out of which, or the circumstances in which, a distribution of profits may be made to members of the company may be imposed by the company's AoA.

Issuing dividends is a form of distribution. Accordingly, a Business (whether as a VPO or SPO) that intends to distribute dividends to its members must ensure that the distribution is made out of profits in accordance with Part 6 of the Companies Ordinance and its AoA.

- (ii) *Dividends*: The general rights of shareholders with regard to dividends and the manner in which they are to be declared and paid is usually stated in the AoA of the company. The AoA can be tailored to the specific intentions of the company in relation to the power to declare dividends, including interim dividends and for the payment and method of payment of dividends in cash and interest free. While the directors have the discretion (subject to the AoA) to declare a dividend, the payment of a dividend may be restrained by court if proper provision has not been made for expenses, or if the dividend is proposed to be paid out of any moneys not available for that purpose (as discussed in section (i) *Distribution of profits*).

A Funder or a Business VPO that has subscribed for shares in a company may therefore receive financial return in the form of dividends. It is possible for a Funder to its entitlement to dividends in a VPO that is in the form of a company, by making provision for it in the AoA of the company (for example, that the company must declare a dividend annually – the standard Model Articles simply provide that the company *may* declare dividends). However, including such a provision in the AoA of a SPO at Level 1 may be more difficult, as it would require amending the SPO's existing AoA which would entail a certain level of paperwork and, depending on the magnitude of funding that is being provided, it may or may not be worthwhile for the SPO to effect the amendment in order to fix the VPO's entitlement to dividends.

If a member receives an unlawful distribution and knows or has reasonable grounds for believing that the distribution was made unlawfully, he is liable to repay it to the company (section 301, Companies Ordinance). This remedy is without prejudice to any obligation imposed in other sections of the Companies Ordinance.

- (b) *Limited partnership*. Financial return may be made to a limited partner when such limited partner redeems the partnership interest.

### 5.3.5 Financial regulatory restrictions.

- (a) *Offering of shares or interests in the VPO or SPO:* The regulatory regime governing the offer and distribution of shares or interests in the VPO or SPO in Hong Kong is primarily contained in (i) the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) (the "**Companies (WUMP) Ordinance**") where the VPO or SPO is structured as a company; and the SFO, which regulates to a large extent the marketing activities associated with the offering of "securities"<sup>3</sup> generally. Accordingly, the offering and distribution of the shares in the VPO or SPO (structured as corporate) in Hong Kong will be governed by both the Companies (WUMP) Ordinance and the SFO. A VPO or SPO seeking to offer shares or interests in securities should note the restrictions below.
- (i) *Restrictions under the Companies (WUMP) Ordinance.* It is an offence for a person to issue, circulate or distribute in Hong Kong any "prospectus" offering for subscription or purchase of shares in, or debentures of, a company (whether incorporated in Hong Kong or elsewhere), unless the "prospectus" satisfies the Companies (WUMP) Ordinance requirements as to content and registration, or an exemption or safe harbour may be relied upon. The definition of "prospectus" is very wide and includes advertisements, brochures or other documents.
- (ii) *Safe harbours to the restrictions under the Companies (WUMP) Ordinance.* Schedule 17 to the Companies (WUMP) Ordinance sets out the safe harbours in which the offering may be made. The more commonly used exemptions include:
- (1) Subject to the inclusion of a specified warning statement, offers made to not more than 50 non-professional investors (i.e., offerees only, not ultimate investors) in Hong Kong within a 12 month offering period (the "**Limited Persons Exemption**") and
  - (2) Offers made only to "professional investors" as defined under the SFO (the "**Offers to Professional Investors**"). Generally, the definition of "professional investor" includes, amongst others, financial intermediaries, authorized collective investment schemes, pension funds, authorized financial institutions, insurance companies and recognized exchange companies, high net worth individuals with a portfolio of not less than HK\$8 million (or its foreign currency equivalent – approximately US\$1.3 million), and corporations or partnerships having either a portfolio of not less than HK\$8 million (or its foreign currency equivalent) or total assets of not less than HK\$40 million (or its foreign currency equivalent – approximately US\$5.2 million).

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<sup>3</sup> "Securities" is defined widely in the SFO as including shares, stocks, debentures, funds, bonds or notes issued by a body (whether incorporated or not) as well as rights, options and interests in relation to such shares, stocks etc. and any interest in any collective investment scheme (other than interests in registered mandatory provident fund schemes or their constituent fund, occupational retirement plans and certain insurance contracts). The definition is not limited to securities issued or traded in Hong Kong.

- (iii) *Restrictions under the SFO.* In addition to the restrictions under the Companies (WUMP) Ordinance which are applicable to offering of shares of a VPO or SPO in the form of a corporate, it is a criminal offence to issue an advertisement, invitation or document, whether in Hong Kong or elsewhere, which the person knows is or contains an invitation to the Hong Kong public to enter into (or offer to enter into) an agreement to buy and sell, amongst other things securities, unless the authorisation of the Securities and Futures Commission is obtained (sections 103 and 105, SFO) or a safe harbour can be relied upon. "Securities" under the SFO include, among other things, shares in companies, interest in a collective investment scheme, interests in limited partnerships and units in unit trusts.

The SFO marketing restrictions are extremely wide and catch all forms of advertisements (which include the oral or written offering documents of any collective investment schemes, as well as fact sheets, key feature documents, pitch books, road show materials etc.) directed at or likely to be accessed or read by the public (or a section of the public) in Hong Kong.

- (iv) *Safe harbours to the restrictions under the SFO.* The following exemptions are frequently relied upon:

- (1) Offers to Professional Investors;
- (2) the common law limited offerees test (the "**Common Law Limited Offerees Exception**") which does not have a bright line threshold number of offerees to which the offer may be made. In our view, offers to 20 to 30, but not more than 50, persons in Hong Kong should not be considered as offers to "the public" and therefore may be acceptable (but with less certainty without the backing of a statutory bright line test); and
- (3) Offers only to persons outside Hong Kong.

- (b) *Engaging in "regulated activities" under the SFO:* Any person (including a corporation or individual) that carries on a business in a "regulated activity" in Hong Kong, or actively markets whether or not in Hong Kong to the Hong Kong public, any service provided which would constitute a regulated activity if provided in Hong Kong must be licensed by or registered with the SFC to engage in the relevant regulated activity, unless an exemption applies (sections 114 and 115, SFO).

Individuals performing any regulated functions for their principal which is a licensed corporation must also apply for a licence to be a licensed representative in respect of the relevant regulated activities accredited to their principal (section 114(3) and (4), SFO).

A corporation that is an authorized financial institution (i.e. a bank, a restricted licence bank or a deposit-taking company) engaged in a regulated activity (other than leveraged foreign exchange trading or securities margin financing) is required to be registered with the SFC (section 114(1) and (2) and section 115, SFO).

Currently, a limited partnership is not an acceptable form of business structure for the purposes of licensing and the SFC will only grant licences to corporations and individuals performing regulated functions for licensed corporations. Accordingly, a limited partnership that intends to engage in any regulated activity would need to consider conducting such activities through an incorporated vehicle.

There are currently ten<sup>4</sup> (soon to be twelve<sup>5</sup>) types of regulated activity specified under the SFO. It is a serious offence to carry out regulated activity in Hong Kong or targeting the investing public of Hong Kong without the required licence or registration, and a person contravening this requirement is liable for a fine of up to HK\$5 million (approximately US\$644,000) and to imprisonment for seven years (section 114(8), SFO).

The more relevant types of regulated activities are Type 1 (dealing in securities) and Type 9 (asset management).

- (i) Type 1 (dealing in securities) regulated activity: Broadly speaking, (i) marketing, offering and distribution of securities; and (ii) inducing another person to trade securities with a view to secure a profit arising from the fluctuations of the value of such securities would constitute dealing in securities. In this model, where shares in the VPO entity (in the form of a corporate) or interests in the VPO entity (in the form of limited partnership) are offered, it would constitute "dealing in securities" and trigger the licensing requirement unless an exemption applies. The most relevant exemption is that if the VPO entity (or its director or general partner, as the case may be) deals "as principal" with "professional investors". This exemption only applies where the VPO entity (as principal) is involved in dealing in securities with "professional investors" as defined in the SFO (whether acting as principal or agent) which includes amongst other categories, banks, fund managers, insurance companies and financial institutions **but does not** include professional investors as defined under the Securities and Futures (Professional Investor) Rules (e.g. high net worth individuals with a portfolio of more than HK\$8 million).
- (ii) Type 9 (asset management) regulated activity: "Asset management" involves managing a portfolio of "securities" or futures contracts for another, and would include managing collective investment schemes (i.e. funds). Where any downstream funding to the SPOs is provided by way of equity, it is likely that the VPO entity and the individuals in

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<sup>4</sup> The ten types of regulated activity under the SFO include dealing in securities (Type 1), dealing in futures contracts (Type 2), leveraged foreign exchange trading (Type 3), advising on securities (Type 4), advising on futures contracts (Type 5), advising on corporate finance (Type 6), providing automated trading services (Type 7), securities margin financing (Type 8), asset management (Type 9) and providing credit rating services (Type 10).

<sup>5</sup> The SFC has proposed to regulate the over-the-counter ("OTC") derivative transactions regime by introducing two new regulated activities: (i) dealing in OTC derivative products or advising on OTC derivative products (Type 11); and (ii) providing clearing agency services for OTC derivative transactions (Type 12). The new Type 11 regulated activity will generally cover any of the following: (i) entering into or offering to enter into an OTC derivative transaction; (ii) inducing or attempting to induce another person to enter into, or to offer to enter into, an OTC derivative transaction; and (iii) giving advice on, or issuing reports or analyses on whether, which, the time at which, or the terms or conditions on which, OTC derivatives transactions should be entered into.

making the investment decisions in subscription for, or sale of, the shares in such SPOs would constitute "asset management" and will need to obtain a Type 9 licence for engaging in asset management activities unless an exemption applies. No exemption appears to be applicable to this model.

In light of the potential regulatory implications set out above and the issues under the MLO, neither funding by way of equity nor debt would be recommended.

### 5.3.6 Tax considerations in the model.

In general, it is uncommon to use an entity or structure domiciled in Hong Kong as a private investment fund vehicle. A fund structured as a limited company in Hong Kong lacks tax incentive and is unable to issue and redeem shares at a price related to the value of the company's underlying assets. Alternatively, there is no dedicated legal framework to set up a Hong Kong domiciled fund structured as a limited partnership.

#### (a) *VPO as a private company limited by shares.*

*Funder(s) in Level 3 providing funds to Business VPO in Level 2:* One of the major issues of this model is that the funds provided by the Funders to a Business VPO will not be tax deductible. The Funders at Level 3 accordingly will not be entitled to any tax deduction for the funds provided, which may serve as a disincentive for the Funders to pursue this model.

*Business VPO providing funds to Business SPO:* The ordinary corporate tax categories will apply. The Business SPO will be entitled to a tax deduction for the interest expense incurred on loans, while the Business VPO will be subject to tax on the interest income received. In respect of dividends, the Business VPO will not need to pay tax on dividends received from the Business SPO. Please refer to section 4 *Profits tax in Hong Kong*.

(b) *VPO as a limited partnership.* The same tax considerations as those described in paragraph (a) above apply, with the difference that partners pay tax on their share of the partnership profits at the partners' respective tax rate (i.e. depending whether the partner is a corporate or an individual). Corporate partners will be taxed at 16.5% while partners who are individuals will be taxed at 15%. Individual partners who have elected to personal assessment to bring together all sources of income subject to Hong Kong tax will be taxed at 15% or his marginal tax rate. Please see section 3.2.2(d) *Partnership – Benefits/considerations for choosing such an SPO* and section 4 *Profits tax in Hong Kong* for further details on the tax considerations that apply to a limited partnership.

## 6. LEVEL THREE QUESTIONS

*These questions relate mainly to the cross-border implications of fundraising by the VPO.*

*Considering the three VPO business models and entities listed in 3.1 above:*

- (a) *Are there any restrictions on fundraising from onshore funders (as grants/donations, equity or debt)? Without If so describe the key restrictions if not already covered in 2.2.; tax implications?*
- (b) *Are there any restrictions on fundraising from offshore funders (e.g. foreign ownership laws, foreign exchange control, different tax treatment, withholdings); tax implications?*
- (c) *Are there any foreign control or sponsor/promoter issues for the entities (e.g. limit on foreign directors or trustees)*

#### **6.1 Restrictions on fundraising from onshore funders**

Fundraising from onshore funders are subject to the financial regulatory regime set out above in sections 5.1.2 and 5.3.5 *Financial regulatory restrictions*.

#### **6.2 Restrictions on fundraising from offshore funders**

Offshore funders are not permitted to engage in any of the regulated activities in Hong Kong unless they are licensed by, or registered with (as applicable) the SFC. Please see section 5.3.5(b) *Engaging in "regulated activities" under the SFO*.

There are no foreign exchange controls, restrictions on entry and repatriation of capital or on conversion and remittance of profits and dividends derived from direct investments in Hong Kong.

Where an offshore Funder (donating directly to an Approved Charity) has generated income with a Hong Kong source, and the offshore Funder is a taxpayer in Hong Kong, the offshore Funder can also claim a tax deduction on donations made to an Approved Charity, against its Hong Kong income.

The offshore Funder will also need to observe any local restrictions that may be applicable to him.

#### **6.3 Foreign control or sponsor/promoter issues for the entities**

There are no restrictions as to the nationality of (i) a director of a private limited company in Hong Kong or (ii) the general partner of a limited partnership.



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**C H A N C E**

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The Asian Venture Philanthropy Network (AVPN) is building a vibrant and high impact venture philanthropy community across the Asia Pacific region. AVPN has more than 160 members of AVPN from 27 countries and has a Member Directory and listing of Events at [www.avpn.asia](http://www.avpn.asia).

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We promote venture philanthropy in the broader philanthropic and social investment communities and provide specific networking and learning services to meet the needs of our members.

AVPN is a non-profit organisation based in Singapore with membership across the Asian region. We are supported by grant funding, sponsors and partner organisations.

We are building a cross-sector network bringing together organisations and individuals from finance, business and the social sector. Our members include venture philanthropy organisations (practicing members) and associates that bring different networks, expertise and experience.

Associate Members include private equity managers, private banks, wealth managers, other financial services organisations, professional service firms, family businesses, corporations through their CSR activities, foundations, universities and government related entities.

We are the hub for news and events focused on venture philanthropy to develop shared learning and best practices. Soon through our new Knowledge Centre we will develop practitioner oriented resources to help scale the practice of venture philanthropy across Asia.

Please visit [www.avpn.asia](http://www.avpn.asia) to learn more and contact us at [info \[at\] avpn.asia](mailto:info@avpn.asia) if you have specific enquiries.

We encourage you to engage with us and support our field building activities through sponsorship, grants, donations, or joining as a member or partner organisation.

Download the "Getting Started in Venture Philanthropy in Asia" guide and legal framework country profiles from [www.avpn.asia/startVPO](http://www.avpn.asia/startVPO)