



Hong Kong

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HONG KONG PROFITS TAX EXEMPTION TO BE EXTENDED TO OFFSHORE PRIVATE EQUITY FUNDS

A Briefing Paper¹ proposing to extend the current profits tax exemption for offshore funds to offshore private equity (**PE**) funds was tabled before the Legislative Council Panel on Financial Affairs by the Financial Services and the Treasury Bureau (the **Bureau**) on 5 January 2015. It is expected that a bill to effect the proposals will be introduced to the Legislative Council (**LegCo**) in the first half of 2015.

The Bureau is recommending 3 key changes:

1. extending the profits tax exemption to offshore PE funds by expanding it to cover investments in private companies incorporated offshore;
2. waiving the current requirement for investments to be arranged by or carried out through SFC licensed persons; and
3. extending the tax exemption to Hong Kong special purpose vehicles (**SPVs**) which are established to hold offshore investments.

The measures are aimed at providing a boost to Hong Kong's PE fund industry. With total capital under management of some US\$111 billion dollars as at the end of September 2014, Hong Kong PE funds accounted for roughly 21% of Asia's

total capital under management in PE. Hong Kong however faces fierce competition from other fund centres, notably Singapore. While Singapore and other countries already have tax exemptions in place for PE funds, Hong Kong PE funds have to put complicated procedures in place to ensure that their returns are not subject to Hong Kong profits tax. The new exemption will make it significantly easier for PE funds to operate in Hong Kong and should attract more offshore funds to Hong Kong in line with the government's aim of cementing Hong Kong's position as Asia's leading asset management centre.

Background

In the 2013/14 Budget, the Financial Secretary, John Tsang, announced the proposal to extend the profits tax exemption for offshore funds to transactions in private companies incorporated outside Hong Kong, so that offshore PE funds can benefit from the profits tax exemption currently available to other offshore funds under the Inland Revenue Ordinance (Cap. 112) (the **IRO**). After 2 years' of extensive consultation with the fund industry and other stakeholders, the Bureau announced its plan to table a bill in LegCo in the first half of 2015 and a briefing paper was submitted to LegCo on 5 January.

The following provides a summary of the proposal as set out in the Briefing Paper. Please note that the proposal will be subject to refinement during the legislative process and thus the final form of the legislation may differ from the current proposal.

¹ Legislative Council Panel on Financial Affairs: Legislative Proposal to Extend Profits Tax Exemption for Offshore Funds to Private Equity Funds (CB(1)385/14-15(02)) which is available on the Legco website at <http://www.legco.gov.hk/yr14-15/english/panels/fa/papers/fa20150105cb1-385-2-e.pdf>.

Limitation of the Current Regime

The existing profits tax exemption for offshore funds was introduced by amendments to the IRO made in 2006. Section 20AC was then introduced to provide an exemption from Hong Kong profits tax for non-resident funds provided that:

- the funds' profits arose from "specified transactions" or transactions that are incidental to specified transactions; and
- the transactions are carried out through, or arranged by, "specified persons" (i.e. corporations and authorised financial institutions licensed or registered under the Securities and Futures Ordinance to carry out such transactions).

Specified transactions are defined broadly to include transactions in securities, futures contracts, foreign exchange contracts, foreign currencies, exchange-traded commodities and transactions consisting in the making of deposits other than by way of a money-lending business. They do not however include transactions in private companies' securities as these are not covered by the definition of "securities". This means that offshore PE funds that derive profits from investments in private companies cannot currently enjoy the exemption. Moreover, offshore PE funds are not necessarily managed by Securities and Futures Commission (SFC) licensed corporations, which is another condition of the exemption.

The New Exemption

The Bureau believes that the initiative proposed will allow offshore PE funds to enjoy the same tax exemption as other offshore funds. The Briefing Paper sets out 3 major proposals:

1. Extending the tax exemption to offshore PE funds

The Bureau recommends amending the definition of "securities" so that a transaction in the securities of an eligible private company (i.e. the portfolio company) will be within the definition of "specified transaction".

Profits derived from investment in a portfolio company will qualify for the tax exemption if the portfolio company:

- i) is a private company incorporated outside Hong Kong;

- ii) did not during the 3 years before a transaction in the portfolio company's securities:

- a) carry on any business through or from any permanent establishment in Hong Kong;

- b) (whether directly or indirectly) hold equity capital or equity interests in one or more private companies carrying on any business through or from any permanent establishment in Hong Kong, where the aggregate value of such capital and interests exceeds 10% of the value of its own assets; and

- c) do any of the following -

- A) hold immovable property in Hong Kong; or

- B) (whether directly or indirectly) hold equity capital or equity interests in one or more private companies directly or indirectly holding immovable property in Hong Kong,

where the aggregate value of the holding of the property mentioned in sub-subparagraph (A) and of the holding of the capital and interests mentioned in sub-subparagraph (B) exceeds 10% of the value of its own assets.

It is a condition of the exemption that offshore private portfolio companies must not carry on business in Hong Kong in the 3 years prior to a transaction in their securities. However, the condition will be considered satisfied where an offshore private company has business activities in Hong Kong which are purely preparatory or auxiliary (e.g. having a showroom) and do not constitute a permanent establishment. The proposal comes with an anti-abuse provision, that subject to a de minimis rule, a private company must not hold equity capital or equity interests in one or more other private companies carrying on any business through or from any permanent establishment in Hong Kong. A private company also must not have had any direct or indirect interest in immovable Hong Kong property with a value exceeding 10% of the value of its total assets in the 3 preceding years.

2. Waiving the current requirement for investments to be conducted or arranged by an SFC licensee

Offshore PE funds may not be managed by an SFC-licensed entity. To ensure that the exemption covers these funds, it is proposed that section 20AC IRO is amended so that the tax

exemption will be available to profits derived from a specified transaction carried out by an offshore PE fund if the fund is a “qualifying fund”. A fund will be a “qualifying fund” if:

- i) at all times after the final close of sale of interests:
 - a) there are five or more investors, who are not associates of the fund’s originator;
 - b) the capital commitments made by investors, who are not associates of the fund’s originator, exceed 90% of the aggregate capital commitments; and
- iii) the portion of net proceeds to be received by the fund’s originator and the originator’s associates from the fund as agreed under an agreement governing the fund’s operation (excluding the net proceeds attributable to the capital contribution of the originator and the originator’s associates) does not exceed 30% of the net proceeds arising from the fund’s transactions.

These thresholds reflect the characteristics of a typical PE fund and aim to ensure that only bona fide PE funds will be eligible for the profits tax exemption.

To prevent abuse of the exemption or local PE funds round-tripping, the existing deeming provisions of section 20AE IRO will also apply to offshore PE funds. Thus a resident person who alone or together with his associates holds a beneficial interest of 30% or more in a tax-exempt “qualifying fund” will be deemed to have derived assessable profits in respect of profits earned by the offshore PE fund from specified transactions and incidental transactions in Hong Kong.

3. Allowing tax exemption for Special Purpose Vehicles (SPVs)

Lastly, the Bureau proposes to extend the tax exemption to gains derived by an offshore fund from the disposal of an SPV which holds an investment in a private company. This is due to the fact that PE funds commonly hold their investments through an SPV and their exit from the investments often involves the sale of the SPV.

It is proposed that an SPV could take the form of a corporation, a partnership, the trustee of a trust estate or a non-corporate body. It would have to be wholly or partly-owned by a non-resident person and must be established for the sole purpose of holding, directly or indirectly, or administering investments in eligible private companies.

The SPV may however be incorporated or otherwise established either in Hong Kong or offshore. This is important as it will allow PE funds to use Hong Kong companies to hold their offshore investments. This proposal is complementary to steps taken by Hong Kong to increase the number of double tax treaties with other jurisdictions with a view to encouraging more funds to hold investments in Hong Kong.

It is also proposed that the profits tax exemption will be extended to an SPV in respect of profits derived from a transaction in the securities of an interposed SPV or an eligible offshore private company.

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