For discussion on
5 January 2015

Legislative Council Panel on Financial Affairs

Legislative Proposal to Extend Profits Tax Exemption for Offshore Funds to Private Equity Funds

PURPOSE

This paper briefs Members on the legislative proposal to extend the profits tax exemption for offshore funds to private equity funds.

BACKGROUND

Objective of the proposal

2. At the end of 2013, the combined fund management business in Hong Kong achieved a record high of HK$16,007 billion, representing a year-on-year growth of 27% from 2012[1]. This puts us among the top asset management hubs in Asia. Given the economic growth in Asia, we are in an advantageous position to attract more funds of various types to operate business in Hong Kong, thereby broadening the variety and scope of our fund business, and facilitating portfolio allocation into the Asian markets.

3. Private equity is an important component of our asset management industry. The total capital under management in private equity funds in Hong Kong reached US$99 billion in end 2013, recording a year-on-year increase of 16%[2]. As at end September 2014, the total capital under management in private equity funds in Hong Kong increased to US$111 billion, accounting for 21% of Asia's total capital under management in private equity.

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[1] Information from the "Fund Management Activities Survey 2013" published by the Securities and Futures Commission.

[2] Information from an industry journal.

4. To strengthen Hong Kong's status as a premier international asset management centre and develop Hong Kong into a full-service, all-round asset management hub, the Financial Secretary announced in his 2013-14 Budget the proposal to extend the profits tax exemption for offshore funds to include transactions in private companies which are incorporated outside Hong Kong. This will allow offshore private equity funds to enjoy the same exemption under the Inland Revenue Ordinance (Cap. 112) ("IRO") as those currently available to other offshore funds.

5. By providing clear tax exemption to transactions conducted by offshore private equity funds in respect of eligible overseas portfolio companies, we hope to attract more private equity fund managers to hire local asset management, investment and advisory services, which will be conducive to further development of our asset management industry. This will also in turn drive demand for other relevant professional services, such as business consulting, tax, accounting and legal services.

Current tax exemption applicable to offshore funds

6. The IRO was amended in 2006 to effect the proposal to exempt offshore funds from profits tax. After enactment of the Amendment Ordinance, under the exemption provisions (section 20AC), non-resident entities are exempt from profits tax for profits derived from "specified transactions" carried out through or arranged by a "specified person" and "transactions incidental to the carrying out of the specified transactions".

7. The scope of "specified transactions" covers those transactions an offshore fund would typically perform in Hong Kong, including 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. As stated in paragraph 6 above, to qualify for tax exemption, the "specified transactions" must be carried out by "specified persons", which include corporations and authorized financial institutions licensed or registered under the Securities and Futures Ordinance ("SFO") (Cap. 571) to carry out such transactions.

8. The current definition of "securities" does not include securities of a private company. In other words, offshore private equity funds that make use of the services of "specified persons" to derive profits from transactions in securities of private companies could be subject to Hong Kong profits tax. We also note that private equity business may not

necessarily be managed by corporations licensed by the Securities and Futures Commission ("SFC") under the SFO.

THE PROPOSAL

9. We have consulted the industry on the legislative proposal to extend offshore tax exemption to private equity funds. The industry welcomes the proposal and has provided views on the implementation details. Taking into account the views gathered, we are finalizing the legislative amendments to the IRO to implement the proposal. The major areas of the proposal are set out below.

(a) Extending tax exemption to offshore private equity funds

10. As stated in paragraph 7 above, the scope of "specified transactions" covers transactions in securities. We propose to amend the definition of "securities" such that a transaction in securities in an eligible private company (i.e. the portfolio company) will not be excluded from a "specified transaction".

11. To qualify for tax exemption, a portfolio company should meet the following conditions -

(a) it is a private company incorporated outside Hong Kong;

(b) at all times within the 3 years before a transaction in securities in the portfolio company, it did not—

(i) carry on any business through or from any permanent establishment in Hong Kong;

(ii) (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, with the aggregate value of which capital and interests exceeding 10% of the value of its own assets; and

(iii) 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 with direct or indirect holding of immovable property in Hong Kong,

with 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) exceeding 10% of the value of its own assets.

12. As set out in paragraph 11(b), we propose to set a clear timeframe that a portfolio company should meet the above conditions at all times within the 3 years before a transaction in securities in the portfolio company to qualify for tax exemption. This would provide certainty for private equity funds. In paragraph 11(b)(i), we propose not to allow the private company to carry on business in Hong Kong. However, the offshore private company may have some insignificant business activities in Hong Kong without giving rise to significant profits tax liability under the provisions of the IRO. If it carries on business activities of a purely preparatory or auxiliary character (e.g. a showroom) without constituting a permanent establishment, this condition will be satisfied.

13. To prevent abuse of the exemption, subject to a de minimis rule, the private company is not allowed to 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.

14. Regarding paragraph 11(b)(iii) in relation to the holding of immovable property in Hong Kong, we propose to adopt a threshold that the value of the immovable property could not exceed 10% of the value of the total assets of the private company. The proposed threshold draws reference from the formulation of the safe harbour rule, concerning the taxation of gains from the disposal of shares in a company holding immovable properties within a contracting party, which is usually

incorporated in the terms of a comprehensive agreement for the avoidance of double taxation ("CDTA")[3].

(b) Allowing offshore qualified private equity funds to enjoy tax exemption

15. As stated in paragraph 8, offshore private equity funds are not necessarily managed by SFC licensees. To allow these funds to also enjoy tax exemption, we propose to amend the existing exemption provisions (section 20AC) such that an offshore private equity fund carrying out a "specified transaction" could be eligible for tax exemption in respect of profits from that transaction if either –

(a) the specified transaction is carried out through or arranged by a specified person; or

(b) the offshore private equity fund conducting the specified transaction is a "qualifying fund".

16. In order to be a "qualifying fund" and hence be eligible for tax exemption, the following conditions must be met -

(a) at all times after the final close of sale of interests –

(i) there are five or more investors, who are not associates of the originator of the fund;

(ii) the capital commitments made by investors, who are not associates of the originator of the fund, exceeds 90% of the aggregate capital commitments; and

(b) the portion of net proceeds agreed, under an agreement governing the operation of the fund, to be received from the fund by the originator of the fund and the originator's associates (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 transactions of the fund.

[3] According to the terms of a CDTA, taxing right is normally retained by a contracting party over gains derived from the disposal of shares deriving more than 50% of their value from immovable property situated within its own jurisdiction.

17. The above proposed thresholds reflect the typical characteristics of a private equity fund, for example, a private equity fund is typically a collective investment vehicle (i.e. an investment vehicle with multiple investors) and not simply a vehicle majority-owned by the fund manager with other investors holding only nominal interest. These aim to ensure that only *bona fide* private equity funds will be eligible for tax exemption.

18. Similarly, for a "qualifying fund" to be exempt from tax in respect of profits derived from transactions in securities in its portfolio company, the relevant portfolio company should meet the conditions as set out in paragraph 11 above.

19. To prevent abuse or round-tripping by local private equity funds and other entities disguised as offshore funds, the existing deeming provisions (section 20AE) will equally apply to offshore private equity funds. That means a resident person (alone or jointly with his associates) holding 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 private equity fund from specified transactions and incidental transactions in Hong Kong.

(c) Allowing tax exemption for Special Purpose Vehicles (SPVs)

20. Private equity funds may use multi-level holding structures to accommodate preferences of fund investors. For example, private equity funds generally set up one or multiple-tier SPVs to hold their portfolio companies. We propose to -

(a) amend the definition of "securities" such that a transaction in securities in an SPV will not be excluded from the definition of a "specified transaction", so that offshore private equity fund will be exempt from tax in respect of profits derived from the transaction in the securities in an eligible portfolio company through disposal of securities in an SPV; and

(b) add an express provision to give tax exemption to an SPV in respect of profits derived from a transaction in securities in an interposed SPV or an eligible offshore portfolio company.

21. We further propose that the SPV, which is a purpose-built structuring tool of private equity funds, could be a corporation, partnership, trustee of a trust estate or a non-corporate body incorporated, registered or appointed in or outside Hong Kong. It can be wholly or partially owned by a non-resident person and should be established solely for the purpose of holding, directly or indirectly, or administering the qualified portfolio company.

WAY FORWARD

22. We are finalizing the Bill, with an aim to introducing it into the Legislative Council in the first half of 2015.

Financial Services and the Treasury Bureau
December 2014