Inland Revenue (Amendment) Bill 2015

Extending Profits Tax Exemption for Offshore Funds to Private Equity Funds

28 April 2015

Asset management industry in Hong Kong

- Combined fund management business (as at end 2013): HK$16,007 billion
- Year-on-year growth of 27% from 2012
- Hong Kong is among the top asset management hubs in Asia

Private equity industry in Hong Kong

- Total capital under management in private equity funds (as at end 2014): US$114.6 billion
- Year-on-year growth of 16% from 2013
- Accounting for 21% of Asia's total capital under management in private equity
- Currently, around 390 private equity companies in Hong Kong

Current tax exemption applicable to offshore funds

Current exemption provisions:

- Non-resident entities are exempt from profits tax for profits derived from -
  - ☐ "specified transactions" (covering those transactions an offshore fund would typically perform in Hong Kong, including transactions in **securities**); and
  - ☐ "transactions incidental to the carrying out of the specified transactions"
- "Specified transactions" must be carried out through or arranged by "specified persons" (corporations licensed or registered under the Securities and Futures Ordinance)

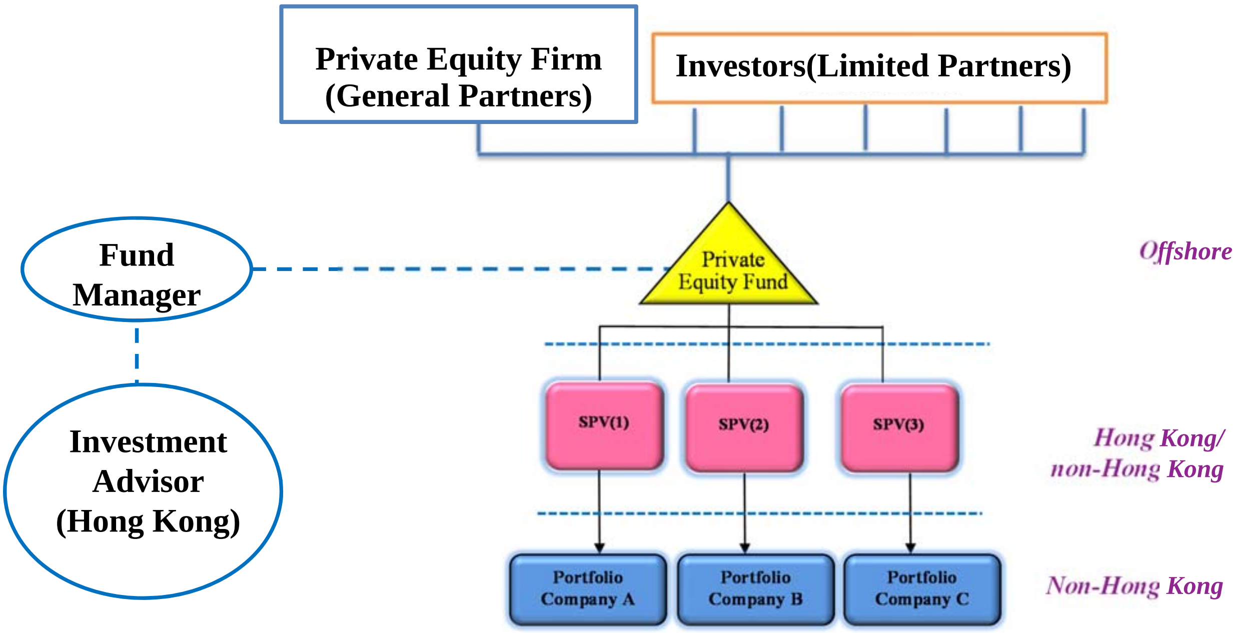
Current tax exemption regime for offshore funds not applicable to private equity funds

- The current definition of "securities" does not include securities of a private company
- Offshore private equity funds that make use of the services of "specified person" to derive profits from transactions in securities of private companies could be subject to Hong Kong profits tax
- Offshore private equity funds are not necessarily managed by "specified person"

Proposal: To Extend Profits Tax Exemption for Offshore Funds to Private Equity Funds

- Policy objectives:
  - ☐ To strengthen Hong Kong's position as a premier international asset management centre
  - ☐ To facilitate the development of the private equity sector
- It is proposed in the 2013-14 Budget to extend the profits tax exemption for offshore funds to private equity funds
- To attract more private equity fund managers to set up or expand their business in Hong Kong, hire local asset management, investment and advisory services, and drive demand for other relevant professional services

A typical offshore private equity fund structure



Legislative Proposal

(a) Extending tax exemption to offshore private equity funds

- To amend the definition of "securities" such that a transaction in securities in an eligible private company (i.e. portfolio company) will not be excluded from a "specified transaction"

- To qualify for tax exemption, the portfolio company –

  (a) must be a private company incorporated outside Hong Kong

  (b) within the 3 years before a transaction in securities in the portfolio company, did not carry on any business in Hong Kong or hold any immovable property in Hong Kong, subject to a de minimis rule

Legislative Proposal

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

- To add a new provision: If the offshore private equity fund conducting the specified transaction is a "qualifying fund", it could be eligible for tax exemption

- To be a "qualifying fund", the following conditions must be met -

  (a) at all times after the final closing of sale of interests –
    (i) the number of investors exceeds 4; and
    (ii) the capital commitments made by investors exceed 90% of the aggregate capital commitments; and

  (b) the portion of the net proceeds to be received by the originator and the originator's associates, does not exceed 30% of the net proceeds arising out of the transactions of the fund

Legislative Proposal

- To prevent abuse, the existing deeming provisions will equally apply to offshore private equity funds, which means -

  A resident person (alone or jointly with his associates) holding a beneficial interest of 30% or more in a tax-exempt private equity fund will be deemed to have derived assessable profits in respect of profits earned by the fund from specified transactions and incidental transactions in Hong Kong

Legislative Proposal

(c) Allowing exemption from payment of tax for Special Purpose Vehicles (SPVs)

- To amend the definition of "securities" such that a transaction in securities in an SPV will not be excluded from the definition of "specified transaction"

- To add an express provision to give exemption from payment of tax to an SPV in respect of profits derived from a transaction in securities in an interposed SPV or an eligible offshore portfolio company

Legislative Proposal

(c) Allowing exemption from payment of tax for SPVs

- SPVs -
  - ☐ could be a corporation, partnership, trustee of a trust estate or any other entity incorporated, registered or appointed in or outside Hong Kong
  - ☐ could be wholly or partially owned by a non-resident person
  - ☐ should be established solely for the purpose of holding, directly or indirectly, and administering one or more eligible portfolio companies

- To add new deeming provisions

Recommendations by the Financial Services Development Council (FSDC)

- FSDC released a report in November 2013, putting forth recommendations regarding tax exemptions for private equity funds and anti-avoidance measures.

- The Bill has taken into account FSDC's major recommendations, including –

(i) setting a 10% de minimis rule to allow portfolio companies to hold minimal immovable properties in Hong Kong;

(ii) allowing funds which are not managed by SFC licensees to also enjoy tax exemption;

(iii) allowing exemption from the payment of tax for SPVs

Way Forward

- The industry generally welcomes the proposal and urges for its early implementation

- The Bill will come into operation on the day on which the enacted Inland Revenue (Amendment) Ordinance 2015 is published in the Gazette

THE END