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Mr Christopher Cheung Wah-fung
Chairman
Bills Committee on Inland Revenue (Amendment) Bill 2015
(Attn: Ms Michelle Lee)

By email: mjylee@legco.gov.hk

Dear Mr Cheung,

Offshore funds exemption – extension to private equity investments

We refer to your letter dated 4 May 2015 inviting JLCT to present its views on the Inland Revenue (Amendment) Bill 2015. We point out that we did make submissions to the Financial Secretary and Secretary for the Treasury on 20 January 2015 in respect of an earlier draft of the Bill, and were gratified to see that many of our comments were taken on board and adopted in the Bill that is before you.

The Bill seeks to extend the so-called "offshore funds exemption" in the Inland Revenue Ordinance ("IRO") to cover private equity investments. We note in particular that a "qualifying fund" as defined in the Bill does not have to use a SFC registered person at all through which to conduct investments (not just for private equity investments). Conversely, a non-resident who is not a "qualifying fund" will be entitled to the private equity exemption if it deals through a SFC registered person.

We wish to offer some comments based on the current draft of the bill.

1. We understand the legislation will not be fully precise, and that some points will inevitably need to be addressed in a DIPN. That said, it is essential that there be no uncertainty as to the application of key provisions of this legislation. Uncertainty will not be beneficial for the private equity industry when crucial questions arise as to the application of this legislation. Covering key issues in an administrative Departmental Interpretation & Practice Note ("DIPN") is not a favoured solution, because DIPNs are not legally binding and are not always applied consistently by the IRD. For this reason, we urge that outstanding issues be dealt with in the legislation itself. We therefore recommend that some further "tidying up" of the bill in necessary.

2. On an initial point, we query whether the correct threshold for Hong Kong real estate holdings, and business assets holdings, is 10%. That might be too low (but ultimately this is a policy

decision for which there is no absolute right or wrong answer). Eg, if a fund invests in a Singapore private company which has many other investments including a relatively insignificant 20% interest in a Hong Kong company, the result could be extreme if the Hong Kong company's shares constitute a very minor portion of the Singapore company's total asset portfolio. (That said, we also see difficulties in the way that this 10% figure is to be calculated as explained below in 5 b. and c.)

3. The definition of "permanent establishment" contains a seeming inconsistency. It includes in the definition a place for the filling of orders ((2)(b)), but then excludes a place (or agent) used for the storage/delivery of goods ((3)(a)). Essentially, these are the same functions. What one sub-section allows the other takes away. This particular form of drafting is due to the fact that the definition incorporates the standard definition in the IRO of "permanent establishment", but then seeks to incorporate exclusions that are contained in the standard OECD model tax treaty. These do not sit easily with each other.

4. The definition of "private company" is key, but is problematic. We appreciate what the Administration has tried to do, but the new definition creates a whole new set of uncertainties. It refers to "a company ... that is not allowed to issue any invitation to the public to subscribe for any shares or debentures of the company". The fact is that no company has carte blanche to issue such invitations without first obtaining appropriate approvals from relevant securities regulator (in Hong Kong, that would be the SFC).

   Under the current definition in the IRO, whether a company is "not allowed" to do this is determined by its articles of association. But, under the new proposed definition, sole regard is no longer to be had solely to the company's articles. If the articles are silent, the fact is that no company (even a listed company) is allowed to issue invitations unless it takes the further step of issuing a prospectus and getting approval from the SFC. This means that even a listed (or a non-private unlisted) company is to be treated as a "private company". On this approach, every offshore company would be a private company – even a listed company! The matter needs to be clarified.

5. The definition of "excepted private company" raises issues too.

   a. The concept of "share capital (however described)" would not in our view catch companies that do not have share capital. We suggest the legislation refer to "share capital (however described) or other ownership interests", in order to clarify what is intended.

   b. The concept of looking at the "value of the holding of the capital" contains anomalies. Eg, the underlying company might hold $1b of real estate, yet it would have nominal value only if it is thinly capitalized (ie, has up to $1b of debt due to its shareholders instead of being fully capitalized). This allows for planning which could not be attacked under the general anti-avoidance provisions in section 61A on those facts alone. (This is because thin capitalization by itself does not demonstrate a dominant tax avoidance purpose.) Instead, we suggest it would be better to refer instead to the value of the underlying real estate in Hong Kong or the value of the gross assets of the permanent establishment in Hong Kong.

   c. A private company might hold real estate in many countries besides just Hong Kong (usually thought various subsidiaries of its own). Measuring the capital of the company would involve effectively counting the foreign real estate, not just the Hong Kong real estate. Again, this shows that it is better to focus on the value of the underlying real estate (or gross business assets) in Hong Kong, rather than valuing the company's shares.

d. The three year period is measured from the date of the transaction that gives rise to the relevant profit. However, profits can arise even if there is no identifiable transaction. Eg, many companies value their assets on a mark-to-market basis each year (ie, they recognize unrealized gains based on fluctuations in market values). There is no "transaction" in such a case; and the actual disposal in the final year will potentially generate only a portion of the total profits in such a case.

e. There is a double counting problem if the offshore private company holds a subsidiary A which in turn holds a subsidiary B which holds the relevant real estate or permanent establishment in Hong Kong. As the Bill is currently worded, the legislation would require the value of the capital in *both* A and B to be counted. This is double counting. This needs to be clarified so as to ensure only single counting is required.

6. We suggest the definition of "special purpose vehicle" is confusing.

a. Clause (c) is redundant because it catches both Hong Kong and foreign formed entities; it excludes nothing. Also, the concept of a trustee being "appointed in or out of Hong Kong" is irrelevant is determining whether this is a Hong Kong trust or not. We suggest it is preferable to focus on where the trustee is based, not the place where the appointment was made (which is a test that can be easily manipulated).

b. Clause (d) imposes a requirement that the parent SPV must not only "hold" the underlying excepted private company" but must also "administer" that underlying company. In a group situation, this is impractical and unnecessary. This is because as a practical matter the administration of the subsidiaries in a group is usually done by the ultimate parent, not by the immediate shareholder companies. This requirement imposes a practical hurdle. We accept that such a condition might be desirable to secure tax treaty protection, but some corporate groups might wish to use interposed companies for reasons unrelated to the use of tax treaties, and we should encourage this without imposing such an artificial requirement. And, if there is a chain of companies, the wording requires that each company in the corporate chain must administer each company below it directly or indirectly, instead of confining administration to a single company. This is very unrealistic and odd.

7. The time of "fund closing" is difficult to apply where the company is an open-ended one (as will shortly be permitted in Hong Kong), because such companies will be continuously raising funds. Also, the definition allows for some manipulation, because an originator could continually move the relevant time by inviting new subscribers into the fund at any time, thereby moving the reference point of time. This needs to be clarified in order to prevent potential tax avoidance.

8. The definition of "special purpose vehicle" also needs refinement.

a. Under section 20ACA of the Bill, in addition to three other qualifying conditions, a special purpose vehicle (SPV) must be "wholly or partially owned by a non-resident person" and "not itself be an excepted private company". However, in contrast to the definition of "excepted private company" contained in the Bill, section 20ACA does not explicitly say that, in relation to this definition of SPV, the condition "owned by a non-resident person" refers to both direct and indirect ownership. Thus, there will be uncertainty where an interposed SPV is wholly owned by another SPV which is a resident of Hong Kong (but only indirectly and ultimately owned by a non-resident fund). The uncertainty is whether such an interposed SPV, which is wholly owned directly by a Hong Kong resident, is an SPV by definition. If the answer is no, any gains derived by the interposed SPV from the disposal of an excepted private company would not be exempt from tax. To avoid this uncertainty, we suggest the relevant qualifying condition should be changed to "wholly or partially owned directly or indirectly by a non-resident person".

b. The condition that an SPV cannot itself be an excepted private company will also create some uncertainty. This would be the case where an overseas incorporated investment holding company is used as an SPV to hold an excepted private company. Conceivably, such an SPV could carry on an investment holding business in Hong Kong (ie dealing in the excepted private company) without the same being undertaken through or from a permanent establishment in Hong Kong (but nonetheless chargeable to profits tax under the IRO). This is the case given that the term "permanent establishment" generally refers to a "distinct place of business with a certain degree of permanence", a threshold which is generally regarded as higher than that of "carrying on business in Hong Kong". As a result, conceptually, such an SPV could be said to be "not carrying on any business through or from a permanent establishment in Hong Kong", ie satisfying condition (a) of the definition of "excepted private company". Where such an SPV also satisfies conditions (b) and (c) of the definition of "excepted private company" (which is likely), the said SPV would by definition be itself an excepted private company and, thus, be excluded from qualifying as an SPV. This does not appear to be the intention of the legislation.

c. Conditions (a), (b), (c) and (d) of the definition of "special purpose vehicle" are tight enough such that only genuine and intended SPVs can benefit from the proposed exemption in the Bill. As such, it appears that deleting condition (e) of the definition, namely, "not itself be an excepted private company" would remove the above mentioned uncertainty without creating any undesirable effect.

We hope you find these comments helpful. If you have any questions or require any clarification, please call me at 29132980.

Yours sincerely,

Michael Olesnicky
for and on behalf of
The Joint Liaison Committee on Taxation