香港稅務學會
THE TAXATION INSTITUTE OF HONG KONG
(Incorporated in Hong Kong as a company limited by guarantee)

CTA
註冊稅務師
Certified Tax Adviser

11 May 2015

Email: mjylee@legco.gov.hk

The Hon Christopher Cheung Wah-fung
Chairman of the Bills Committee
Inland Revenue (Amendment) Bill 2015

Dear Hon Christopher Cheung,

Inland Revenue (Amendment) Bill 2015: Extension of the profits tax exemption for offshore funds to private equity funds

We refer to the captioned bill and would like to make the following submission for the consideration of the Bills Committee.

Firstly, we support the policy objective of the government of promoting the development of the fund and asset management industry in Hong Kong by extending the current profits tax exemption for offshore funds to private equity funds

With this policy objective in mind, our submission is as follows:

1. Excepted private company (EPC) should be allowed to carry on business in Hong Kong and be incorporated in Hong Kong

   The current legislative intent is that in order to enjoy the proposed exemption under the bill, a private equity fund (PE fund) cannot make an investment in a private company (i.e. an EPC) which carries on <u>any</u> business in Hong Kong through or from a permanent establishment (PE) in Hong Kong. In order to avoid a PE fund to circumvent the restriction, a complicated rule is set under which where such an EPC, itself not carrying on any business in Hong Kong through or from a PE in Hong Kong, holds a private company which does so, the capital value which the EPC holds in the private company concerned cannot exceed 10% of the total asset value of the EPC. In addition to being complicated, the rule may also disqualify some investments made by a PE fund in an offshore holding company which holds a private company which carries on certain business in Hong Kong through or from a PE in Hong Kong. This would be the case where the capital value held by the holding company in the private company concerned exceeds the 10% threshold, albeit the principal business of the said private company and the holding company may be conducted outside Hong Kong. This outcome may not be desirable.

   In fact, given that a property trading or investment business undertaken by an EPC in Hong Kong (which is understandably not encouraged by the government) has already been separately restricted under a separate rule contained in the bill, we consider that it may not be necessary at all to impose the restriction that an EPC cannot carry on <u>any</u> business in Hong Kong through or from a PE in Hong Kong. For example, there is no apparent reason why a PE fund cannot invest in a potential start-up technology company in Hong Kong, and can only invest in a similar company in Shenzhen or anywhere else outside Hong Kong.

We therefore urge the government to consider removing the restriction that an EPC cannot directly, or indirectly through a private company it holds, carry on <u>any</u> business in Hong Kong through or from a PE in Hong Kong (i.e. only restricting an EPC not to directly or indirectly carry on a property trading or investment business in Hong Kong would suffice). Such an EPC would of course itself be subject to tax in Hong Kong under the normal provisions of the Inland Revenue Ordinance (IRO) if the said EPC carries on business in Hong Kong through or from a PE in Hong Kong, but this should not affect the proposed exemption of a PE fund in respect of its gains derived from the disposal of the EPC.

Furthermore, given that what an EPC can or cannot do in Hong Kong has already been prescribed in the bill based on the legislative intent discussed above, there is also no apparent reason why an EPC must be incorporated outside Hong Kong in order for a PE fund to enjoy the exemption. In the circumstances, the requirement that an EPC must be incorporated outside Hong Kong would not further facilitate the achievement of the legislative intent. We understand there is a thinking that a company incorporated in Hong Kong is by definition a Hong Kong asset and should therefore not fall within from the scope of the proposed exemption. Conceptually, we do not consider that an exemption under a statute has to be considered in this manner; a statute can of course exempt what would have otherwise been a taxable item based on the policy consideration of the government concerned. In any case, this thinking has already been refuted by other provisions of the bill, under which a PE fund would still enjoy the proposed exemption under section 20AC when it disposes of a special purpose vehicle (SPV), even if the SPV is incorporated in Hong Kong.

As such, and in order to facilitate PE funds to invest in Hong Kong businesses, we also propose that the requirement that an EPC must be incorporated outside Hong Kong be removed.

2. The definition of "special purpose vehicle" may need refinement

   a. Under section 20ACA of the bill, in addition to three other qualifying conditions, an 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 might be some 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 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 may 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 (i.e. dealing in the excepted private company) without the same being undertaken through or from a PE in Hong Kong (but nonetheless chargeable to tax under section 14 of 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", i.e. 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.

   We understand that the legal draftsman considers that if condition (e) is not added to the definition of SPV, this would affect the application of the deeming provision under section 20AF of the bill. However, this does not appear to us to be the case. Even if an SPV is also by definition an EPC, it would not affect the application of section 20AF so long as it also falls within the definition of SPV.

   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 of 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.

3. The definition of "final closing of sale of interests" contained in section 20AC (6) is difficult to apply where a fund is an open-ended one. Also, the definition by referring to "the originator last accepts subscriptions from investors" 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 rectified.

4. Different start dates for the amended section 20AC, and sections 20ACA and 20AF under the bill.

   We understand that the intention is to have the whole bill, when enacted, effective for transactions occurring on or after 1 April 2015. However, sections 20ACA and 20AF of the bill, as they are currently drafted, can apply to transactions occurring as early as 2 April 2014 (which differs from the start date of the amended section 20AC as applying to transactions occurring as on or after 1 April 2015). This would be the case as, unlike the amended section 20AC which refers to" transactions carried out... from 1 April 2015" for its start date, sections 20ACA and 20AF refer to any or a year of assessment commencing on or after 1 April 2015 for their start date. As a result of the operation of the system of basis period for a year of assessment in Hong Kong, transactions occurring as early as 2 April 2014 could fall within the year of assessment commencing on 1 April 2015, i.e. the year of assessment 2015-16. These different start dates for the relevant sections need to be rectified.

We hope you find our submission helpful. If you have any questions or require any clarification, please contact us at 28100438.

Yours sincerely,

Joseph Yau
President
For and on behalf of
The Taxation Institute of Hong Kong