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(English version only)

Hon. Kenneth Leung, Chairman
Bills Committee on Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018
By email

11 January 2019

Dear Mr. Leung

We welcome the opportunity to provide a submission on the Inland Revenue (Profits Tax Exemption for Funds)(Amendment) Bill 2018 ("the Bill").

The introduction of a unified fund tax regime is a significant step forward in the development of Hong Kong as an international financial center for fund and wealth management. The amendments to the Hong Kong Profits Tax ("HKPT") exemption to capture both (a) offshore and onshore funds and (b) investments in offshore and onshore private companies are viewed very favorably by the funds industry, together with the pragmatic approach to remove the tainting provision and apply a two-year holding period test for investments in private companies (which do not hold Hong Kong immovable property). It is very pleasing to see that the industry's feedback during the consultation process has been taken into consideration and a number of the measures suggested have been incorporated into the Bill. As such, we believe that the new rules will have a significant, positive impact on the participation of private equity funds in the unified fund tax regime, which will consequently contribute to the development of Hong Kong as a wealth and asset management hub.

From a private equity perspective, we foresee a few areas in the Bill which may not result in the unified fund tax exemption being workable. Accordingly, our comments focus on the private equity context and ensuring the unified fund tax regime works, from both a technical and practical perspective, for the majority of private equity funds. There are other concerns or uncertainties in the rules from a broader funds perspective (e.g. whether the definition of a fund will capture pension funds and the exclusion of interest income for credit funds) but our views on such issues were included in our previous submission dated 27 April 2018. We have not included these comments again but have focused on certain aspects critical to private equity funds as it was the private equity sector that has had very limited uptake and participation in the current HKPT fund exemption. We believe that if we can get the unified fund tax exemption to apply to the majority of private equity funds, this will significantly assist in promoting and enhancing Hong Kong's attractiveness as a center for wealth and asset management

1. Definition of a "fund"

Private equity funds come in a range of forms and structures. Due to the range of investors, investments/asset types, investment jurisdictions and regulatory considerations, there is no consistent structure that is typically applied across funds. In our experience, there are often blocker vehicles and multiple feeder vehicles in addition to the master fund, as well as holding platforms and potentially parallel funds, within the overall fund arrangement.

The definition of a fund, as contained in Section 20AM of the Bill, is derived from the definition of a "collective investment scheme" in the Securities and Futures Ordinance and is broadly intended to

apply to all funds. However, it is unclear whether the definition, as currently worded, will sufficiently capture (or be interpreted broadly enough to include) all types of private equity funds and their respective fund entities.

This is particularly important as these fund entities may be unable to satisfy the definition of a Special Purpose Entity ("SPE") (i.e. where they also hold investments other than interests in investee private companies) and therefore, may be taxable on any Hong Kong sourced profits. Accordingly, we believe there are certain entities within the fund arrangement that may fall outside the definition of a "fund" and "SPE" leaving them subject to HKPT. We believe that it is not the policy intent to create a mismatch in the tax treatment but rather a result of the unique characteristics of private equity funds.

Please refer to Appendix 1 for an illustrative example of a typical private equity fund and the potential issue. In particular, our concern centers around whether "Cayman/HK Super HoldCo" would qualify as a "fund" as it would not fit the definition of a SPE based on the Bill, potentially resulting in it being subject to HKPT on Hong Kong sourced profits. As the adoption of a Hong Kong or offshore "Super HoldCo" is a typical structure adopted by private equity funds, we expect this uncertainty in application of the rules to have a significant impact on the uptake and participation of private equity funds in Hong Kong.

2. Qualifying assets / transactions of a fund and SPE

Similar to the above, holding companies within a private equity fund may hold investments other than interests in an investee private company. The Bill provides for a separate scope of qualifying assets/investments held by a fund (as outlined in Schedule 16C of the Bill) and a SPE, with the latter limited to investments in private companies only. While we appreciate the aim of the SPE provisions (and therefore, the need for a definition of a SPE), we consider a more pragmatic and simplistic approach to be to allow SPEs to invest in the same qualifying assets/investments as that of a fund. Otherwise, a legitimate holding company within a fund arrangement, could potentially be subject to HKPT on its profits, where such profits would be exempt in the hands of the fund, if held directly. In our view, this outcome does not align with the overall aim of the unified fund tax exemption. Please refer to Appendix 2A and 2B for illustrative examples of this issue. In particular, it seems to be inconsistent that an exit by way of an IPO can be made at the fund level but not at the SPE level and that a fund but not SPE can hold/trade non-performing loan.

3. Holding and administering activities of an SPE

Holding companies in the private equity context will often undertake certain management activities relating to its investment in a private company (for example, financing and other management activities such as hedging, divestment decisions and shareholder reserve matters). We would generally consider that these holding companies should meet the definition of a SPE, as they are solely holding and administering investee private companies and do not carry on any trade or activities except for the purpose of holding and administering investee private companies. However, based on the IRD's previously published guidance on this matter in the Departmental Interpretation and Practice Note ("DIPN") No.51¹ these financing and management activities of the holding company would likely be considered to exceed "holding and administering" activities of a SPE. As a result, the holding company could fail to satisfy the SPE definition and potentially be subject to HKPT. This issue is also illustrated in Appendix 2C.

¹ DIPN No.51 relates to "SPVs" under the offshore fund regime. As the "SPE" definition is modelled on the "SPV" definition, we have assumed that the same/similar interpretation would apply.

Potential solutions

The above issues are interlinked and we do not believe that the potential solutions should be considered on an isolated basis. Accordingly, we detail below our suggestions to rectify the potential issues within the Bill and enhance its overall effectiveness for private equity funds.

The definition of a "fund" could potentially be clarified by the issuance of DIPN by the IRD. However, given the significance and potential impact to private equity industry, we do not consider this option to be viable nor provide the appropriate level of certainty necessary. Instead, we would suggest adding a sub-provision within Section 20AM(2) of the Bill that states *"...for the avoidance of doubt, a fund includes the fund and its wholly-owned entities..."* to provide clear, legislative certainty in the application of the rules. We believe that such certainty would have a significant and positive impact on the participation of private equity funds in the unified fund tax regime.

We believe that the second and third issues would also be resolved by the above approach, thereby removing the need for a SPE definition altogether. Alternatively, expanding the definition of a SPE to include the same assets/investments as a fund (i.e. qualifying assets/investments outlined in Schedule 16C of the Bill) may also provide the same desired outcome. Although, this may lead to the question as to why a SPE needs to be defined and included in the Bill.

Concluding remarks

We regard the first issue to be the key priority. As highlighted above, if this area of concern can be appropriately resolved, and the definition of a "fund" can be defined and/or interpreted in a broader sense, the second and third issues will, from a practical perspective, disappear. This is on the basis that any wholly-owned entity of a fund, that is unable to meet the definition of a SPE, can still avail itself of the HKPT exemption. We believe this approach aligns with the policy intent.

The aim of the HKPT exemption for funds is to promote and enhance Hong Kong's attractiveness as a center for wealth and asset management. While we acknowledge that the HKPT exemption for privately offered funds are designed to apply to all funds (and broadly, the current offshore fund regime and proposed unified fund regime, as contained in the Bill, are effective for several types of funds, e.g. hedge funds), the unique nature of private equity funds makes the design of the HKPT exemption challenging. That said, to meet the Hong Kong Government's overall policy aim, it is critical that at least the majority of legitimate, private equity funds can effectively apply the unified fund exemption.

We trust that the above is helpful. Should you wish us to elaborate on any of the above points, please feel free to contact us.

Yours sincerely,

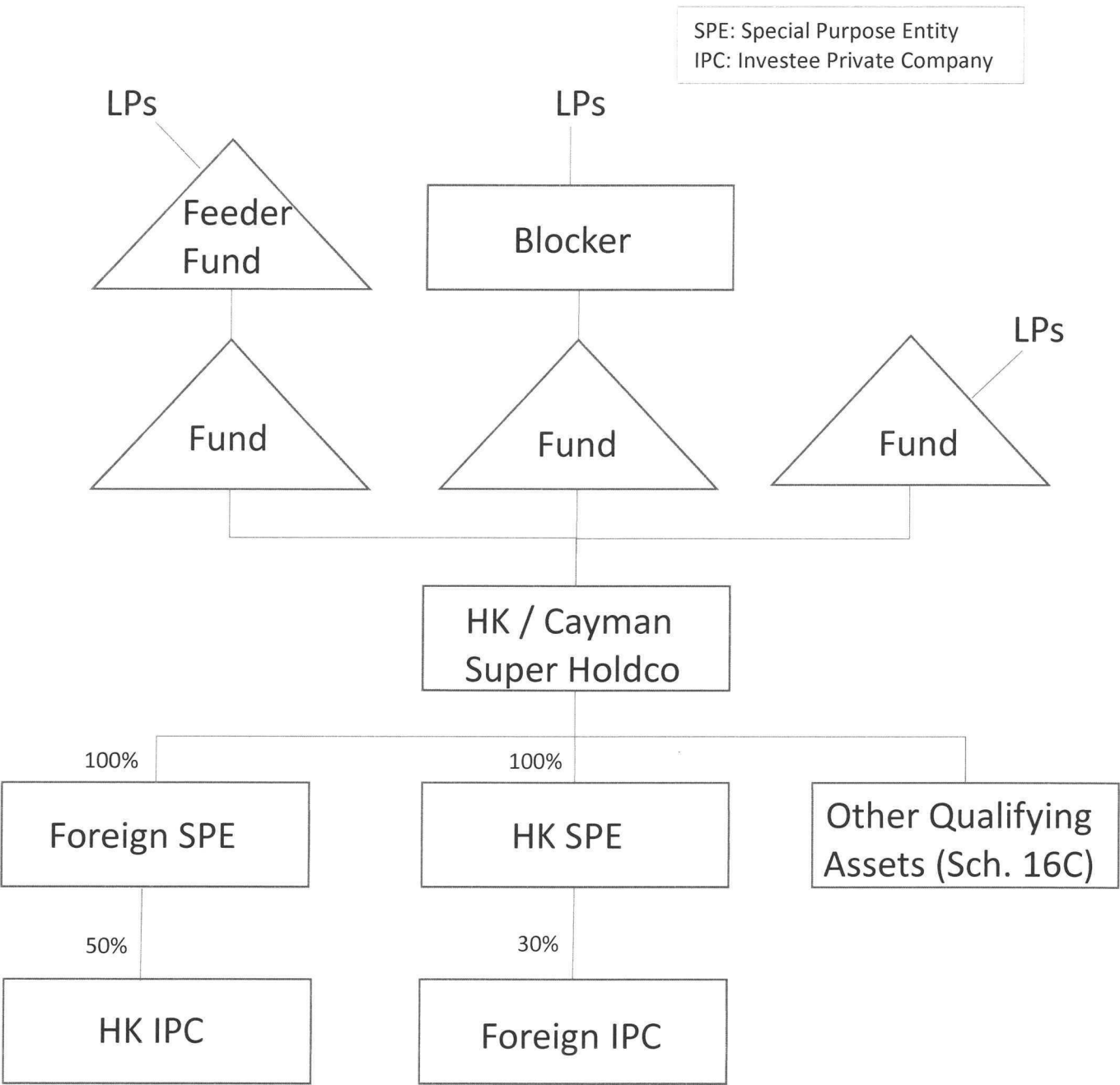


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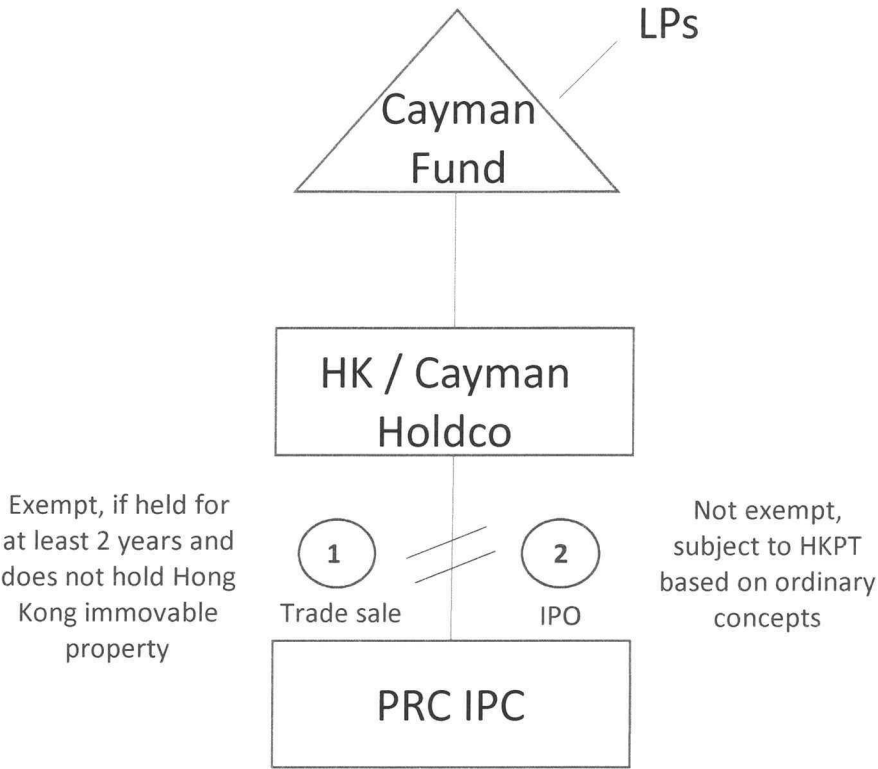
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Appendix 1: Example Private Equity Fund

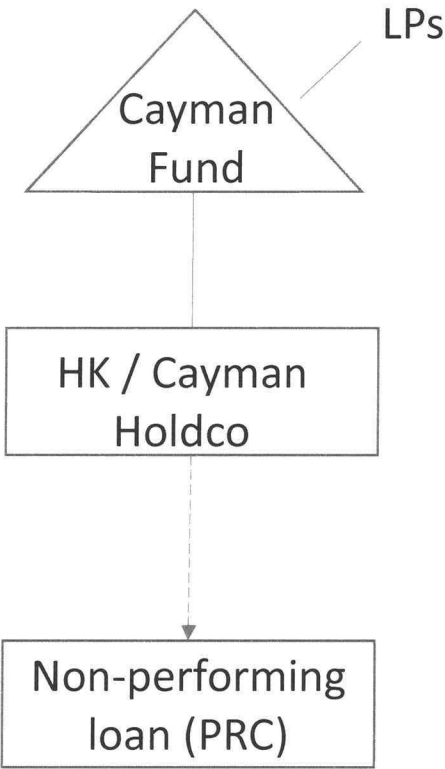


Appendix 2A: SPE Variations in the Private Equity Context

IPC: Investee Private Company



Appendix 2B: SPE Variations in the Private Equity Context



Appendix 2C: SPE Variations in the Private Equity Context

IPC: Investee Private Company

