HK 私投 募資 VCA
Hong Kong Venture Capital and Private Equity Association
香港創業及私募投資協會

Profits Tax Exemption for Funds
Inland Revenue (Amendment) Bill 2018

HKVCA is delighted to see the amendments that are included in the "Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018". We had strongly supported the Extension to the Offshore Funds Tax Exemption in 2015 to improve the tax treatment of offshore funds making investments in unlisted securities. Unfortunately, the Inland Revenue Department's DIPN 51 made the 2015 Extension very unattractive for Private Equity and Venture Capital ('PE/VC') firms.

The proposed Amendment contains four key features that we believe will substantially improve Hong Kong's attractiveness as a base for PE/VC activity. The most significant clarifications are that a tax exemption will be provided to Funds where:

1. There is no tainting of a Fund as a result of having one or more non-compliant Investments
2. Investments in Hong Kong-based companies are treated similarly to offshore Investments
3. Investments held for longer than two years are tax exempt
4. The Fund may be Hong Kong-based or offshore based

We are also pleased to see the clarification that Sovereign investors will be able to benefit from the Amendment. Hong Kong's future development as a centre for PE/VC activity will be much enhanced if Sovereign Wealth Funds and Pension Funds choose to base their Asian operations here.

Our experience has been that, whilst the legislative wording is essential to establish the framework for the clarification of future tax treatment, the application of tax policy and assessment of individual cases is also critical to having certainty for PE/VC firms resident in Hong Kong. This concern is particularly important in an industry where there are a great variety of forms for Fund vehicles, Fund Managers and the types of Investment they generate. We look forward to a new DIPN that reflects the wording in this Amendment.

There are some areas where, in the short time we have had to review the Amendment's wording, we have some uncertainty as to how the law will be applied:

a) Definition of a "Fund":
   i. Although Sovereign investors are clearly included, the wording seems to indicate that Pension Funds that have obtained the Section 26A exemption status will not need to rely on the exemption under the Bill. We believe however that there are many Pension Funds, and special purpose entities of Pension Funds, that will not qualify for Section 26A treatment, please thus clarify whether such Pension Funds, and special purpose entities, also qualify as Funds under the Bill (notably where the management of the Pension Funds are employees of, and beneficiaries of, the company that is providing and operating the Pension Plan);
   ii. There are PE/VC vehicles where, for their own reasonable corporate governance purposes, the management team is employed by the Fund vehicle, or employed by a subsidiary set up under the Fund. Proposed section 20AM(5)(b) appears to exclude such structures, so please clarify whether this would be excluded from a definition of Fund;

iii. From time to time an investor may wish to create a "Fund of one" with that investor as the sole Limited Partner in the Fund. Does such a Fund meet the definition for a Fund as set out in this Amendment?

iv. From the wording of the Amendment, it would appear that a Fund operating through an Advisor not licensed in Hong Kong would be at a disadvantage to those operating through a licensed person, as the unlicensed entity would need to demonstrate there are at least 4 investors in the Fund;

v. Employees in the Manager (or an LP which is a non-fund entity) sometimes co-invest with the Fund in underlying investments through a parallel Fund vehicle. Will such parallel vehicles be allowed tax exemption – even though (in the case of an employee vehicle) they include employees;

vi. In the context of a private equity Fund where there may be multiple "feeder" vehicles in addition to a "master" fund vehicle, "parallel" fund vehicles(s) or "holding platform" entities, please clarify that the definition of "Fund" is broad enough (or will be interpreted broadly enough) to capture each of these entities in the overall fund complex, where such entities do not satisfy the definition of "SPE" or "interposed SPE";

b) An investment in an unlisted security that is sold by a Fund after 2 years will obtain tax exemption. It is unclear how that investment would be treated if the unlisted security becomes listed and is sold within two years of having been acquired, if held by a SPE;

c) Please clarify whether a Fund can invest in a private non-corporate entity (e.g. "partnership", "trust" etc) and obtain the same benefits as if the investment had been in a private "company"?

d) We appreciate the general clarity apparent in the tests for tax-exemption. We are not sure however of the purpose of excluding investments with high proportions of short-term assets. If this additional test is considered essential, should the test be on the proportion of short-term assets held in Hong Kong (rather than the global proportion of short-term assets);

e) Is there flexibility in the future to refine the definition of qualifying investment categories. Investment strategies, such as Credit Funds, may justify similar treatment to that given to Equity Funds;

f) We believe that it is broadly understood that a "business undertaking for general commercial or industrial purposes is not a Fund" but request a little more detail around these terms to ensure there is clarity on what activity is excluded;

g) There is welcome detail provided on the way in which Special Purpose Entity ('SPEs') will be treated – but there is concern in the industry that the timescale for obtaining Tax Residency Certificates for SPV/SPEs is taking many months (rather than the anticipated three weeks);

h) Whilst Hong Kong resident Funds/Managers may give substance to SPEs that conduct only holding and administering activities, a non-resident Fund may wish to have some management activities in the SPE for reasonable commercial purposes. For example, (i) financing and other management activities (e.g. hedging), (ii) certain management decision making in respect of its investments, such as shareholder reserve matters, etc. This may exceed what is considered solely "holding and administering" a private company, therefore tainting the SPE's entire tax exemption, based on the current interpretation of DIPN 51;

i) Where a Fund co-invests alongside an ITVFC in a Hong Kong-based company, can it use a SPE?

We believe the proposed legislative changes have the potential to make Hong Kong a more attractive base for Private Equity and Venture Capital activities and appreciate the much improved clarity and flexibility of the 'tests' for tax-exempt treatment.

Clearly the industry will gain confidence in the measures proposed if it is possible to obtain clarifications on the above areas where there may be some uncertainty at present.

John Levack 11/1/2019
Vice Chairman of HKVCA

About HKVCA

HKVCA represents over 430 members. Members include 240 private equity firms, managing US$1.5 trillion of assets globally, across all types – including all of world's Top 10 largest PE firms as well as small VC investors. These firms are engaged in venture capital and private equity investments in the Asia-Pacific region at all levels – from venture, growth, buyout, secondary, pension, fund of funds and family offices.