

# Hong Kong Tax alert

## **Inland Revenue (Amendment) Bill 2015 gazetted to extend Profits Tax Exemption for Offshore Funds to Private Equity Funds**

### **Executive Summary**

The Budget for 2013-14 first proposed that the Inland Revenue Ordinance's (IRO) profits tax exemption for offshore funds (Offshore Funds Exemption), to be extended to private equity funds (PE Funds). The extension was provided for in the long anticipated Inland Revenue (Amendment) Bill 2015 (the Bill), which was introduced in the Legislative Council on 25 March 2015.

Under the current Offshore Funds Exemption, the Inland Revenue Department's (IRD) current interpretation is that transactions in most shares and other related interests in private companies do not fall under the definition of "specified transactions". Accordingly, profits derived by offshore PE Funds from investing in private companies could be subject to Hong Kong profits tax.





To develop Hong Kong into a full-service asset management hub, the Bill was introduced to allow offshore PE Funds to access the Offshore Funds Exemption and therefore enjoy similar certainty in taxation as other funds investing in non-private companies. The Bill made key amendments to various provisions of the Offshore Funds Exemption in order to:

- ▶ extend the Offshore Funds Exemption to include transactions in securities of, or issued by, certain private companies incorporated outside Hong Kong;
- ▶ waive the requirement for transactions to be carried out through or arranged by “specified persons” for “qualifying funds”; and
- ▶ exempt “special purpose vehicles” (SPVs) formed for the purpose of holding and administering targeted private companies from the payment of profits tax to the extent the SPVs are owned by an exempt fund.

This alert provides an overview of the current Offshore Funds Exemption (including its limited application to PE Funds), key features of the Bill and our views on the Bill.

### **The current Offshore Funds Exemption**

The current Offshore Funds Exemption was enacted in 2006, to provide for the exemption of non-resident persons from profits tax if their activities in Hong Kong are restricted to “specified transactions”, carried out through or arranged by “specified persons”, and transactions that are incidental to the “specified transactions”. “Specified persons” generally refers to persons licensed by the Securities and Futures Commission (SFC).

However, offshore PE Funds investing in private companies are generally not able to take advantage of the current exemption regime due to limitations imposed under the current definitions of “specified transactions” and “specified persons”. For example, transactions in the securities of a private company are not included in “specified transactions”, and it is relatively uncommon for PE Funds to be managed by “specified persons”. Therefore, offshore PE Funds are taxed in a relatively unfavorable manner compared to other offshore funds.

### **Key features of the Bill**

The key amendments introduced by the Bill and set out in further detail below, include:

- ▶ Extending the Offshore Funds Exemption to include transactions in the securities of, or issued by, certain private companies incorporated outside Hong Kong (referred to in the Bill as “excepted private companies” (EPCs));
- ▶ Extending the Offshore Funds Exemption to SPVs which are established to hold directly or indirectly one or more EPCs;
- ▶ Waiving the requirement for transactions to be carried out through or arranged by “specified persons” for “qualifying funds”.

### **Who qualifies as an EPC?**

One of the key obstacles for an offshore PE Fund to take advantage of the current Offshore Funds Exemption is the exclusion from the “specified transactions” listed in Schedule 16 of the IRO of the securities of private companies. The Bill, remedies this by expanding the coverage to include securities of an EPC and/or SPV. An EPC is defined as:

- ▶ A private company incorporated outside Hong Kong; and
- ▶ Satisfies the following conditions at all times within the 3 years before a transaction giving rise to the relevant profits is carried out –
  - a) Did not carry on any business through or from a permanent establishment in Hong Kong; and
  - b) Falls within either one of the following descriptions –
    - i. It did not hold (whether directly or indirectly) share capital (however described) in one or more private companies carrying on any business through or from a permanent establishment in Hong Kong;
    - ii. It held such share capital, but the aggregate value of the holding of the capital is equivalent to not more than 10% of the value of its own assets; and
  - c) Falls within either one of the following descriptions –
    - i. It neither held immovable property in Hong Kong, nor held (whether directly or indirectly) share capital (however described) in one or more private companies with direct or indirect holding of immovable property in Hong Kong;
    - ii. It held such immovable property or share capital (or both), but the aggregate value of the holding of the property and capital is equivalent to not more than 10% of the value of its own assets.



### **Who qualifies as an SPV?**

Since SPVs are commonly used by PE Funds for structuring investments and the formulation of exit strategies, the Bill also grants a profits tax exemption to SPVs in respect of profits derived from the disposal of an EPC or of an interposed SPV.

Under the Bill, an SPV is broadly defined to include a corporation, partnership, trustee or other entity which fulfils all of the following conditions:

- ▶ Being wholly or partially owned by a non-resident person;
- ▶ Being established solely for the purpose of holding, directly or indirectly, and administering one or more EPCs;
- ▶ Being incorporated, registered or appointed in or outside Hong Kong;
- ▶ Does not carry on any trade or activities except for the purpose of holding, directly or indirectly, and administering one or more EPCs; and
- ▶ Not being itself an EPC.

The exemption for SPVs allows offshore PE Funds to use Hong Kong incorporated or resident companies as an investment holding platform for offshore investments. This should be conducive to the development of Hong Kong as an investment holding jurisdiction and to the SPVs taking advantage of the tax treaty network of Hong Kong. It however, remains to be seen whether an SPV formed solely for the purposes of holding and administering from Hong Kong an EPC under the Bill would create enough "substance" in order to claim treaty benefits. This is particularly the case given the increasing emphasis that some jurisdictions, including mainland China, are placing on substance, often taking account of factors such as employees hired, business operations and assets when determining whether to grant treaty benefits or not

An important point to note is that an SPV need not be wholly owned by an exempt fund, it is possible for an SPV to be jointly owned by an exempt fund and other person(s), regardless of whether the other joint venture partners are Hong Kong residents or not, which should facilitate co-investment structures and joint ventures. However, it should be noted that if the other joint venture partner(s) of an SPV are not an exempt fund, the profits of the SPV are only exempt to the extent the SPV is owned by the exempt fund. However, from a tax compliance perspective, this would require the SPV to ascertain whether its shareholders are exempt funds or not.

It is worth noting that in respect of SPVs, additional exempted investments have been introduced under the Bill, being "rights, options or interest in; and certificates of interest or participation in, temporary or interim certificates

for, receipts for, or warrants to subscribe for or purchase, shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by an EPC or an interposed SPV". As such, offshore PE Funds which derive gains from the trading (i.e., buying and selling) of these types of instruments, including debt and hybrid debt/ equity investments, should be covered by the extended exemption regime under the Bill.

However, based on the current IRD view, credit funds which derive a significant part of their income, from the receipt of interest or distributions from the holding of said instruments, rather than trading them, would not be able to claim that the said interest or distributions were derived from "specified transactions". This is because in the IRD's view, "transactions" refers to the buying and selling of an instrument, rather than the mere holding of an instrument in order to derive passive income, and therefore the passive receipt of Hong Kong sourced interest and distributions of a revenue nature, is regarded as income incidental to the "specified transactions". Where the incidental income of a PE Fund exceeds the 5% threshold of the total relevant income of the PE Fund for a year, the whole amount of the incidental income, including the relevant interest or distributions received from these types of instruments, would then be subject to tax in Hong Kong.

### **Waiving the requirement of transacting through a "specified person" for "qualifying funds"**

Under the current Offshore Funds Exemption, specified transactions must be carried out through or arranged by a "specified person". Given PE Funds do not usually appoint an SFC-licensed person in Hong Kong, this requirement prevents many offshore PE Funds from enjoying the current Offshore Funds Exemption. To provide for the exemption from profits tax of offshore PE Funds, the Bill broadens the current requirement for transactions to be carried out through or arranged by a specified person, to also apply to transactions of "qualifying funds".

In order to only benefit genuine offshore PE Funds, a "qualifying fund" has to satisfy all of the below conditions:

- ▶ The number of investors (other than the originator and its associates) exceeds 4 at all times after the final closing of sale of interests;
- ▶ The capital commitments made by investors (other than the originator and its associates) exceed 90% of the aggregate capital commitments; and
- ▶ The portion of the net proceeds arising out of the transactions of the fund to be received by the originator and its associates, after deducting the portion attributable to their capital contributions, is agreed under an agreement governing the operation of the fund to be an amount not exceeding 30% of the net proceeds.



By requiring that a qualifying fund has to have more than 4 investors, PE Funds which have less than five feeder funds as their investors may not be regarded as a qualifying fund, even though looking through the feeders, such funds may have more than 4 investors.

#### A new deeming provision to tax resident persons' shares of profits in exempted SPVs

The current Offshore Funds Exemption is intended for non-residents only. In order to discourage round-tripping of funds by Hong Kong residents, there is a deeming provision contained in section 20AE of the IRO. Under the deeming provision where a non-resident fund is owned by a Hong Kong resident (the triggering ownership threshold being 30% for those non-associated with the fund; and any percentage for those associated) the resident investor would be deemed to derive a corresponding proportion of the exempted profits of the non-resident fund as their assessable profits in Hong Kong. Furthermore, the resident investor will also have the obligation to report the same to the IRD.

Under the Bill, a new section, (section 20AF) is added as an additional deeming provision to deem a Hong Kong resident investor's share of the exempted profits of an SPV, through their interests in an exempt PE Fund, to be their assessable profits in Hong Kong on terms similar to those of the existing deeming provision. This new deeming provision is required because, unlike non-resident funds exempt under the current regime, the profits of an exempt PE Fund may not be made at the fund level but at the level of the SPV and, as such, the current deeming provision may not apply.

Nonetheless, similar to the current deeming provision, where an exempt PE Fund is "bona fide widely held", the new deeming provision would not apply to a Hong Kong resident investor regardless of their percentage of ownership in the exempt PE Fund. However, it appears that a new set of rules for determining whether a PE Fund is "bona fide widely held" may be warranted. This is the case given that PE Funds will less likely have more than 50 investors, 50 investors being one of the current criteria used by the IRD for accepting that a non-resident fund is "bona fide widely held".

#### Providing for other related matters

In addition to the above, attention should also be paid to the following related matters stated in the Bill:

- ▶ The extended exemption regime to PE Funds and SPVs will apply to transactions carried out for the year of assessment commencing on or after 1 April 2015.

#### ▶ In relation to EPCs:

- ▶ "Private company" defined under the Bill would also change the current definition of the term under the IRO which now strictly follows that contained in the Companies Ordinance. A "private company" is defined in the Bill to mean "a company incorporated in or outside Hong Kong that is not allowed to issue any invitation to the public to subscribe for any shares or debentures of the company";
- ▶ "Permanent establishment" defined in the Bill is largely consistent with the existing definition under Inland Revenue Rule 5, but with certain significant added exclusions. These exclusions are: "the use of facilities solely for storage, display or delivery of goods or merchandise belonging to the company"; "the maintenance of stock of goods belonging to the company solely for storage, display or delivery, or for processing by another business"; and "the maintenance of a fixed place of business solely for purchasing goods or merchandise or for collecting information, for the company".
- ▶ In relation to "qualifying funds", additional terms including "capital commitment", "aggregate capital commitment", "net proceeds" are defined under Section 20AC(6); and
- ▶ The definitions of certain terms like "associates", "associated partnerships", "control", "and principal officer" are refined, expanded or newly introduced.

#### **Our views**

We welcome the proposed legislation as it provides clear tax exemption for transactions conducted by offshore PE Funds in respect of EPCs or SPVs. This will help attract more PE Fund managers to set up or expand their business in Hong Kong and hire local asset management, investment and advisory services, which will be conducive to the further development of our asset management industry.

While the Bill has included certain changes to the existing provisions and introduced additional provisions catering to PE Funds, it should not impact offshore funds which already enjoy the current exemption regime.

Meanwhile, practitioners in the PE Fund industry should get familiar with the requirements set out in the Bill and consider making changes to their existing operating model in order to best leverage the extended Offshore Funds Exemption.

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