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

Offshore Funds Tax Exemption

Extension for Private Equity & Venture Capital Investments

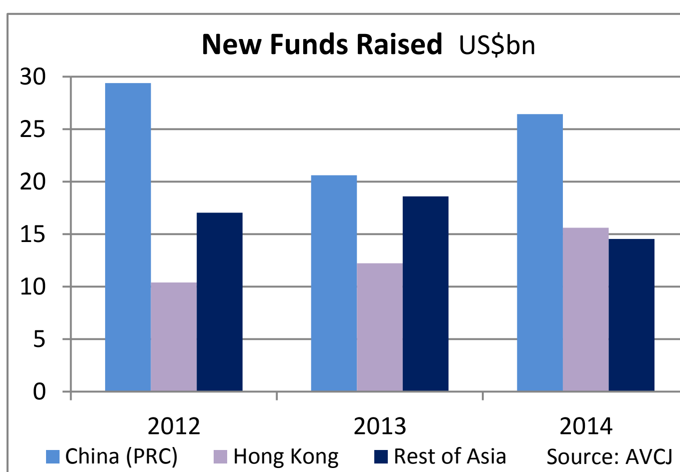
Why is an amendment necessary?

The Offshore Funds Tax Exemption (2006) made it possible for non- SFC authorised funds such as Hedge Funds investing in listed securities and other qualified investments to be 'Managed' from Hong Kong without bringing the Offshore Fund onshore in Hong Kong for tax purposes. At the time that this legislation was drafted, investments in private companies ('Private Equity') were not included in the definition of 'specified transactions' that qualify for the exemption.

The rationale of the 2006 Tax Exemption law, which facilitates Hedge Funds being managed from Hong Kong, also applies to Private Equity funds. By encouraging Private Equity firms to upgrade their 'Advisory' activities in Hong Kong to 'Manager' activities means that more of the fund management activity can be carried out in Hong Kong, leading to increased efficiency, increased local employment, increased tax collections and enhancing Hong Kong's attractiveness as a centre for Private Equity in Asia.

Is Private Equity important?

Private Equity (PE) is a subset of the fund management sector which takes equity positions, both minority and majority holdings, in (mainly) private companies – and holds these investment for the medium term (normally 3-7 years). In most investments, this long holding period allows the Private Equity investors to seek various ways to improve the operations of the companies where they have invested. PE includes Venture Capital, which funds early stage entrepreneurial companies.



Private Equity is well established in Asia, with over US$160bn raised in the last 3 years (23% of this by HK-based firms). At end-2014, Hong Kong firms 'advise' on US$110bn of Private Equity capital (19% of the Asian total).

Hong Kong is the leading single centre for Private Equity in Asia (PRC is larger, but fund activity is dispersed across the country) – and capital raising in HK is growing at a 3 year CAGR of 26%.

Private Equity firms are not large employers (the members of HKVCA on average have 12 employees per firm in HK (Source: HKVCA survey in 8/2014)) as the investment teams are small. They do however outsource a considerable amount of value-added services to accounting and legal firms, fund administrators, consultants, insurers, investment bankers - and PE firms generate a stream of IPO candidates for the stock market.

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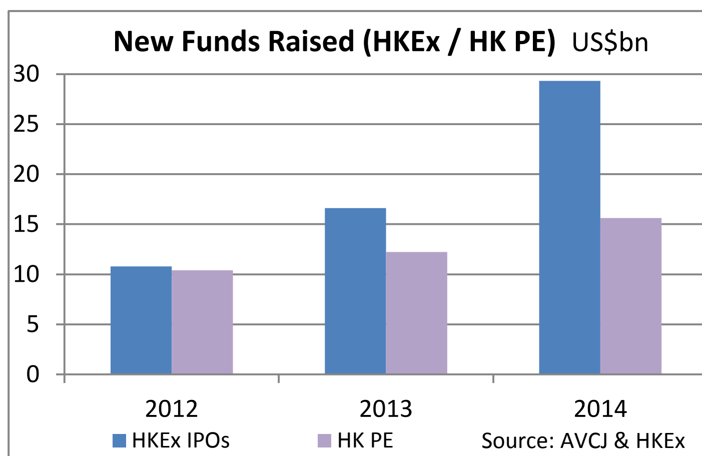

Over the last 3 years, Hong Kong Private Equity firms have raised an amount equivalent to 67% of the amount of capital raised by IPOs on HKEx.
28% of all IPOs on HKEx in this 3 year period had a Private Equity investor (Source: HKVCA Research).

Impact of extension of Bill to cover Private Equity investments?

At present nearly all Private Equity firms based in Hong Kong have an offshore Fund and offshore Manager – with a Hong Kong entity that is restricted to being an Adviser in order not to drag the Offshore Fund into the Hong Kong tax net. This restriction limits the activities performed in Hong Kong – and also significantly limits the ability of HK-based firms to demonstrate 'substance' in Hong Kong for claiming the benefit of Double Tax Agreements (DTAs).

Investments flowing from a Fund to an Investee company are often routed through a specially created company (known as a Special Purpose Vehicle or SPV) in a jurisdiction which has a DTA with the country of domicile of the Investee. Destination countries are becoming more selective in applying treaty benefits to foreign investors, requiring that the entity claiming DTA protection has 'substance' in the country of origin.

Hong Kong has signed 32 DTAs (and is growing its tax treaty network) and is a good location for establishing SPVs. The Amendment will enhance Hong Kong's attractiveness as (i) both the Offshore Fund and the SPV will be treated as tax neutral, (ii) the SPV will be allowed to perform 'administering' functions and (iii) the Manager would also be based in Hong Kong.

By allowing offshore PE funds to be Managed from Hong Kong, many firms will expand the activities that can be performed here (where previously only Advising was possible). This will improve efficiency, create more jobs, increase taxation and make Hong Kong a more attractive destination for new firms.

What are the limitations?

The Amendment, as drafted, has been through a number of rounds of industry / FSTB consultation which has been helpful in making the extension attractive. There are still a few areas where we believe there could be improvements:

- The Amendment applies only to Offshore Funds that are investing in private companies outside Hong Kong. Over the last 10 years, only 8% of all investments of HK-based PE firms have been made in HK-based Investee companies, but this proportion may increase as Venture Capital investment into early stage HK-based companies is becoming more attractive. As written, it looks as if a single investment in a HK-based Investee will disallow the entire Fund from the

benefits of the Exemption. We believe that a HK-based investment by an Offshore Fund should be subject to the ordinary tax rules and that the remaining qualified investments in the Fund should still benefit from the Exemption. That is, the tax exemption of the remaining qualified investments will not be 'tainted' by a HK-based investment.

- The Amendment applies to 'qualifying funds' which are managed by non-SFC licensed Managers in Hong Kong, but the definition in the Amendment excludes some key Private Equity funding vehicles (such as Sovereign Wealth Funds, PRC State Owned Enterprises and pension funds) that are single entities ultimately representing many interests. A number of these entities are already present in Hong Kong – and are an increasingly important part of the Private Equity network.

Future for Hong Kong Private Equity

We believe that Hong Kong can strengthen its position as the leading hub for Private Equity in Asia – giving potential for growth. Hong Kong offers unique advantages in its geographical position, its depth of Private Equity managerial talent and depth of professional advisory services available in one location and the combination of regional overview and China focus.

To optimise its attractiveness and efficiency as a Private Equity hub, further changes in the future will be needed:

- Whilst this Amendment allows the Managers to come onshore in Hong Kong, we believe there are even larger gains to be made by changes that will allow the Funds to come onshore in Hong Kong.
- China is transitioning from being primarily a destination for inbound investment to being a source of capital for outbound investment. Hong Kong should be playing an active role in advising China's cross border investments.
- As onshore activities increase, there will need to be some consequential upgrading to HK laws (Limited Partnerships), regulatory and tax rules as they apply to Private Equity activities.

Support for the Amendment

HKVCA is strongly supportive of this Amendment as a positive step to enhance the attractiveness of Hong Kong as a Private Equity hub for new arriving PE firms and as a way of deepening the engagement for firms already operating in Hong Kong and simplifying their operating structure.

John Levack
Vice Chairman of HKVCA

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About HKVCA

HKVCA represents over 300 corporate members. Members include 160 private equity firms, managing US$1 trillion assets globally, across all types – including 7 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.