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

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24/F Central Government Offices
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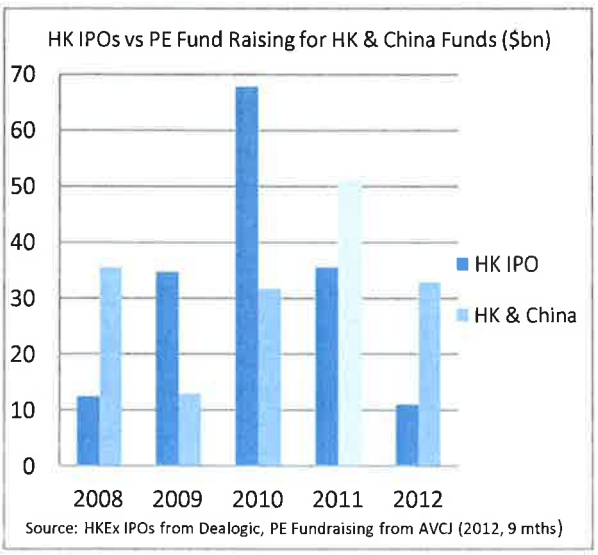
Hong Kong

Dear Julia

Consultation exercise for the 2013 Policy Address

The Hong Kong Venture Capital and Private Equity Association ('HKVCA') would like to contribute to the consultation exercise in advance of the 2013 Policy Address.

The HKVCA is concerned that, without government intervention, the prominence of Hong Kong as the leading centre in Asia for private equity will be undermined. The current structure of the industry, which has worked well for over two decades, will not remain competitive - as there have been changes in the way that benefits under double tax treaties are granted (requiring substance in addition to legal form). Hong Kong's current tax arrangements cause problems for international (offshore) fund investors, if operational substance is created in Hong Kong.



Private equity has been a low-profile industry, directly employing just a few thousand people in Hong Kong. The industry however has a substantial impact, in terms of the capital it deploys, the indirect jobs it creates and the economic benefit it creates: in providing growth capital to finance business expansion and buyout capital to fund transfer of ownership. Private equity is receiving considerable support in the mainland for these reasons – and, at a time when mainland private equity firms are seeking

to raise more international capital, Hong Kong *should be* in a position to play a significant leading role in the future as the designated asset management centre of China pursuant to the 12th 5-Year Plan. Unfortunately, with the current tax structure many PRC firms will pass over Hong Kong and establish international operations in Singapore. A number of firms already resident in Hong Kong are considering moving key parts of their organisation to Singapore, in spite of a commercial preference for staying in Hong Kong.

The changes that the HKVCA would like to see are in two forms: there are some changes to interpretations and exemptions in Hong Kong's tax and securities laws that would have an immediate impact on Hong Kong's competitiveness and secondly some reforms to company law, partnership law and tax law that would allow private equity funds and their managers to come onshore. This second category of change will clearly require a much longer timescale for implementation: the first category of change requires no new primary legislation.

Background

At present the typical structure of a private equity fund is (i) Offshore **Fund**, (ii) Offshore General Partner / **Manager** and (iii) Onshore **Advisor**.

(i) The vast majority of the capital in **Funds** is sourced from international investors outside Hong Kong. Since investing in private companies is not covered in exemptions given to other fund management activities (mutual funds and hedge funds) there is a risk that **Funds** could be taxed in Hong Kong. Private equity firms seek to make profits on long term capital gains – but there is no definition of a capital gain in Hong Kong that gives comfort to our international investors that such capital gain is not taxed in Hong Kong. The **Funds** are thus obliged to remain offshore.

(ii) Hong Kong is the preferred location for many teams that operate private equity **Funds**. If the **Management** of the offshore **Funds** is performed in Hong Kong, the **Funds** could become taxable in Hong Kong through the creation of a Permanent Establishment. Private equity firms are therefore forced to establish their **Managers** offshore and deliberately create certain activities offshore of Hong Kong to avoid a Permanent Establishment being created here. Certain **Management** functions are therefore carved out and performed offshore in a less than optimal manner.

(iii) Whilst many members of the private equity team may be based in Hong Kong, they will ensure that their activities fall under the role of **Advisor**. This is inefficient, costly and creates many commercial and operational issues, but from a legal point of view it is clear that an **Advisor** operating in Hong Kong does not bring the **Fund** onshore for tax purposes.

None of this complicated structuring is done with the intention of avoiding tax due in Hong Kong. The capital committed to **Funds** is very largely sourced from outside Hong Kong and is very largely invested outside Hong Kong and is seeking to make a capital gain (something that is not taxed in Hong Kong). For the **Funds** to raise capital from outside Hong Kong, it is absolutely key to those non-Hong Kong investors that they have complete certainty that they will not be subject to Hong Kong tax via the **Fund** vehicle**.** We believe the IRD has no intention of trying to tax these **Fund** entities. The existing tax rules in Hong Kong however leave the *possibility* that Hong Kong will or could tax the **Funds**. No tax advisor or auditor is prepared to provide a clean sign off on a **Fund** structure where a possible tax liability exists. We are therefore forced into a position where we have to establish an unnecessarily complex structure which eliminates this risk of tax.

The downside for private equity firms has been that they have had to introduce more complicated internal procedures and incur extra administrative cost. Now that major investment destinations (China, India and Australia) have said they will honour double tax treaties where there is substance in the source country for this investment, the 'old' arrangement will no longer work. The **Advisor** role in Hong Kong is not 'substance' for a tax treaty and **Managers** will increasingly be looking to locate themselves in the same country as their **Fund** (or intermediate holding entity) to link 'substance' and source country for the purposes of these double tax treaties. This will not work in Hong Kong where there remains a risk that 'substance' required for the purposes of the double tax treaty could also mean Hong Kong tax (or the *possibility* of tax) for the **Fund**.

The current model structure (**Fund** & **Manager** located offshore and only the **Advisor** onshore) has an unfortunate corollary for Hong Kong. There are a number of functions that have to be performed offshore – relating to fund establishment, legal and accounting advice, fund raising, fund administration & record keeping, decision making committees, boards of directors and audit – which would be better performed in Hong Kong. *The current structure costs Hong Kong jobs.*

The second major disadvantage is that the **Manager** is kept offshore – and it is the **Manager** that collects the full profits from the fund management activity. In the current arrangements, the **Manager** pays a fee to the **Advisor** but this will always be only a part of the total income of the **Manager** - as important functions of the management process are forced to be kept outside Hong Kong. *Tax collection from Hong Kong private equity firms would increase if* ***Managers*** *could come onshore.*

If **Funds** and **Managers** come onshore in Hong Kong, there would need to be some consequential changes to the regulatory regime applied in Hong Kong by the SFC.

Why the need for change?

The difficulty in claiming treaty benefits for Hong Kong advised Funds, together with Singapore having established an attractive structure, is forcing private equity firms to rethink their structures. Briefly, Singapore already has a very strong network of double tax treaties, to which it has added (i) clarity that there will be no tax on capital gains made by private equity **Funds** and (ii) that the onshore **Managers** of those Funds will pay corporation tax at 10% and will be able to create the 'substance' necessary for the tax treaties. The result is two-fold:

1. **Funds** with a Hong Kong **Advisor** and offshore **Manager** are considering moving key components of their business to establish **Fund** platforms and onshore **Managers** in Singapore (despite preferring a Hong Kong location for most other purposes).
2. PRC based firms (which today constitute the largest component of Private Equity in Asia by both number of firms and capital under management) are increasingly looking to raise US$ **Funds** from outside China – and will need a location with an internationally acceptable legal system. Our experience is that Hong Kong would be their preferred choice for most reasons other than tax – but the tax disadvantage will see most choose Singapore.

Conclusion

Hong Kong has been an extremely important centre for Private Equity in Asia. Lack of clarity on the Hong Kong taxation of the **Fund** entity resulted in structures that worked – but only by going offshore, at a cost to both jobs and tax revenue for Hong Kong. That structure no longer works efficiently, due to changes in interpretation of double tax treaties.

If Hong Kong can change some of its tax rules to clarify that Private Equity **Funds** with international investors will not pay tax in Hong Kong and that **Managers** can operate here with no tax impact on the **Fund**, then the threat of losing protections under tax treaties will be solved and, longer term, **Funds** coming onshore in Hong Kong will create new jobs and additional tax revenue whilst consolidating Hong Kong's leading position in this industry.

Yours sincerely

P.P.

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Chairman