



2<sup>nd</sup> February 2018

Ms Carrie Chang  
Principal Assistant Secretary  
For Secretary for Financial Services and the Treasury  
Financial Services and the Treasury Bureau  
24/F Central Government Offices  
2 Tim Mei Avenue, Tamar,  
Hong Kong

By email to: [carriechang@fstb.gov.hk](mailto:carriechang@fstb.gov.hk)

Dear Carrie

**Consultation on Proposed Amendments to the  
Inland Revenue (Amendment) (No. 4) Bill 2017 (“the Bill”) on OFCs**

Many thanks for the opportunity on 30<sup>th</sup> January to listen to your explanation on the proposed changes to the Open-ended Fund Company (OFC) legislation. The Hong Kong Venture Capital and Private Equity Association (HKVCA) welcomes the chance to comment on the consultation paper.

**Introduction**

The membership of the HKVCA includes a large majority of the private equity firms based or having offices in Hong Kong and we share FSTB’s desire to cement Hong Kong’s position as the leading cross-border Private Equity centre in Asia. We believe the creation of competitive onshore fund legal entities is an important part of the updating needed for Hong Kong to retain its leading position. We are therefore highly supportive of FSTB’s initiatives to create an efficient OFC for Hong Kong.

The Private Equity sector has a significant preference for Limited Partnerships as the legal entity for Private Equity funds. It is unlikely that many Private Equity firms will choose to use OFCs for their funds. We understand, however, that FSTB is considering applying a similar logic and process to updating Hong Kong’s offshore fund exemption regime under Section 20AC and Section 20ACA of the Inland Revenue Ordinance and the creation of a new Hong Kong limited partnership vehicle suitable for private equity funds. This initiative will be very valuable to Private Equity firms if the resultant Limited Partnership structure is competitive with existing Limited Partnerships frameworks in other jurisdictions.

It is likely that any Limited Partnership reform in Hong Kong will follow similar lines as those proposed for the OFC. We therefore comment in the spirit that some of HKVCA’s suggestions may not be relevant/apply to the OFC, but should be considered if Limited Partnership reform moves forward.

## Comments on the Proposed Amendments

### 1. We are extremely pleased to see two substantial improvements that:

- a. Discard the ‘tainting’ that one non-complying investment in a fund would have on the residual investments – replacing this with a method where non-complying investments are subject to normal tax assessment whilst the rest of the fund’s investments benefit from a tax exemption.
- b. Treat investments in Hong Kong companies in the same way as investments in non-Hong Kong companies.

We trust that these two principles will be applied to any future Limited Partnership reform – and would also be adopted to amend the extension of the Offshore Funds Tax Exemption enacted in July 2015 that allows firms investing in unlisted securities to be managed from Hong Kong. The over-riding of Sections 20AC and 20ACA of the Inland Revenue Ordinance and DIPN 51 to include these two concepts may make the July 2015 legislation usable by the Private Equity sector.

### 2. The proposed exclusions on investments in private companies (as described in Para 7 of your Proposed Amendments) are understandable obstacles to avoid tax leakage and property investments. Our comments on these two clauses are:

- a. Whilst probably aimed at restricting investments into Hong Kong residential property, the definition used here may cause problems for infrastructure investors (an important component of Private Equity – and an asset management class that is critical for Belt & Road initiatives)
- b. Specifically identifying for unfavourable treatment those control investments where 50% of a private company’s assets have been held for less than three years may cause some concern about tricky future assessments that might give rise to unexpected tax assessment. In principle, however, the Private Equity investments most likely to have a high proportion of new assets are early-stage tech investments (where control shareholdings are unusual). Where a fund concentrates on making investments where the fund has a controlling shareholding, the investee companies are normally owners of more mature assets. As you appreciate, a start-up company’s balance sheet will have minimal fixed assets and likely fluctuating cash balances. The cash movements may breach the “50%” and “3 years” tests under paragraph 7(b). We understand that it is not the intention for cash to be included as part of the control interest and would like clarification in this regard.

### 3. Treatment of non-compliant investments. HKVCA believes that any investments that are non-compliant and excluded from the fund’s tax exemption should be taxed as prescribed in the Hong Kong tax code – but with a clarification of when an investment is a capital gain. Private Equity is a financial investment that is generally seeking to make a capital gain. As discussed on 30th January, over 85% of PE & VC investments in Asia over the last 10 years have been held for longer than 24 months (Source: AVCJ)

We believe that clarity on any gains being made by a Private Equity or Venture Capital Fund based in Hong Kong, and held as an investment for longer than 24 months, should be treated as capital gains. This logical clarification would provide certainty for funds based in Hong Kong that is not possible under Para 7(b) in the Proposed Investments.

4. **Extrapolating the comment above in 2(a) regarding infrastructure investors**, the OFC's minimum investor requirement is restrictive on fund vehicles established by Sovereign Wealth Funds and Pension Funds (which provide a substantial portion of infrastructure investment capital). These investors are increasingly establishing offices in Asia (thus far, many of whom have chosen HK over other Asian cities) to oversee investments in Asian funds and, more often than in the past, directly into investee companies in Asia.

Such institutional investors represent a very important component of a successful Private Equity fund centre and a key ingredient of the fund ecosystem and are often a "fund of one". The OFC's minimum investor requirement limits the marketability of OFCs to these institutional investors.

### Summary

The Proposed Amendments are a significant step towards making the OFC a competitive fund structure. The amendments remove an important area of concern for HKVCA as to how effective a similar exercise in Limited Partnerships would be. HKVCA has some concerns about the practicability of Para 7(b) and believes that, in a Private Equity context, a clarification that an investment holding longer than 24 months would constitute a capital gain, would be more appropriate.

Yours sincerely



**John Levack**  
Vice Chairman of HKVCA

### About HKVCA

HKVCA is a member-based trade association which was established in Hong Kong in 1987 currently with 401 members of whom 240 are Hong Kong based private equity managers across the full spectrum of the industry from venture capital, through growth capital and growth buyouts to institutional fund investors, fund of funds and secondary investors. HKVCA represents small teams investing in start-ups as well as 8 of the 10 largest global private equity firms.