HKVCA 私投募資
香港創業及私募投資協會
The Association for Private Capital in Asia

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By email to: ingridwong@fstb.gov.hk

Dear Maurice,

Consultation on the
'Proposed Refinements to Hong Kong's Foreign Source Income Exemption (FSIE) Regime for Passive Income'

Many thanks for spending time with us on 19th July to provide your views on the Proposed Refinements to Hong Kong's Foreign Source Income Exemption (FSIE) Regime for Passive Income. The Hong Kong Venture Capital and Private Equity Association (HKVCA) welcomes the chance to comment on the consultation paper – and is strongly supportive of this initiative by FSTB to avoid Hong Kong being added to EU blacklist.

Introduction

HKVCA represents a majority of the Private Equity and Venture Capital firms based in Hong Kong and shares FSTB's desire to cement Hong Kong's position as the leading financial centre in Asia.

We agree with the general framework as set out in the consultation paper and believe the intention of replicating pillar two's concept of excluded entities is essential. As most fund managers are not required to prepare consolidated financial reporting, the direct impact of the proposed changes to the fund industry is limited. However, we do have some suggestions (as detailed below) that mostly relate to how to optimize the regime and to ensure that overseas fund managers and family offices are not discouraged to reside in Hong Kong due to unfavorable policy changes.

Definition of Investment Fund

As mentioned by Benjamin during our meeting, the Hong Kong regime will follow pillar two to include "excluded entities" in the law. We believe this is essential and implies that the policy is supportive of the development of the fund industry. However, the definition of investment fund in Hong Kong is different from the GloBE rules, apparently. Since the FSIE regime will not

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override existing tax regimes and laws, we recommend FSTB to consider replicating the definition from the GloBE rules to avoid any hassle during the negotiations between HKSAR and EU.

In addition, a fund registered under the LPF ordinance, which is subject to register with the Companies Registry in Hong Kong, is confirmed to be regulated under Hong Kong jurisdiction. It therefore implies that a HK LPF will be counted as an investment fund under the GloBE rules. To make to clear to market participants, we suggest FSTB to list out all kinds of excluded entities, including funds, in the legislative document.

Economic Substance Rule

We were pleased to hear the confirmation that outsourcing is permitted to count towards economic substance. We believe fund structures currently in the market do allow a fund manager to provide sufficient evidence to prove the relationship between fund manager, fund and SPVs using existing registration documents. It should therefore not be necessary to compose an additional service agreement, which could create additional administrative burden to both fund manager and the fund.

Aside from that, the majority of PE firms' substances are at the sub-advisor level, thus it is necessary to indicate that outsourcing substance rule covers both the fund manager as well as its sub-advisor.

Besides, global/regional fund managers would be reluctant to prepare a separate agreement for a single SPV which might be a small portion of their entire portfolio. The idea of the need to provide for a separate agreement could discourage renowned investors from opening a branch in Hong Kong and/or deploy capital in Hong Kong companies.

Participation Exemption Test

As discussed in our recent meeting, we understand that the proposed participation exemption test will focus on the legal entity paying the dividend (or in relation to which there is a disposal gain) rather than taking into account the entire consolidated group from which the income has been derived. This is problematic because typically private equity funds investing via a Hong Kong platform will invest in a portfolio group and very often the top company in that target portfolio group is a mere holding company that will very likely derive significant passive income (with the active income being paid up from the underlying subsidiaries).

Per our understanding, the EU may resist expanding this rule by taking a look-through or consolidated approach as the participation test is already considered a concession. While we appreciate the feedback in this regard, we do note that the test is said to be derived from the Dutch participation rules and we would like to confirm that the Dutch rules *do* have look-through features. Under the Dutch rules, what is provided is a test that looks at the aggregated (non-consolidated) underlying assets (it is an asset-based test rather than passive income test). More specifically, for purposes of the asset test, a Dutch taxpayer should prepare an aggregated (non-consolidated) balance sheet of all assets held by both its direct subsidiary and indirect subsidiaries in order to determine whether less than 50% of the assets can be considered to be passive.

This aggregated (look-through) approach can be derived from both the literal wording of the applicable provision of the Dutch participation exemption regime and any relevant (parliamentary) guidance. Furthermore, and in line with this approach, share interests in subsidiaries should be eliminated from the aggregated balance sheet.

The Dutch approach takes into account the underlying active assets of the subsidiaries rather than just the first-tier legal entity. As we do not want Hong Kong to be treated less fairly than EU member states, we would recommend FSTB to consider whether a look-through approach can indeed be applied under the Hong Kong proposed test.

Family Office and Corporate Investment Arm

With regards to consolidated financial reporting, two types of private market investors, namely family offices and corporate investment arms, may potentially be in-scope.

Under the proposed Family-owned Investment Holding Vehicles (FIHV) regime, only family investment vehicles with central management and control (CMC) in Hong Kong will be exempted from tax. It is important that the FIHV exemption will override the FSIE regime. However, overseas family investment vehicles without CMC in Hong Kong which are currently not covered by the FIHV tax regime would be impacted by the FSIE. If we would not amend the local CMC requirement under the FIHV rule, overseas family offices with CMC overseas will be reluctant to invest through Hong Kong.

Besides, the FSIE regime may also impact corporate investment arms, which may consolidate some of their investment holding vehicles as a result of being the investment manager and also seeding a meaningful proportion of capital in the funds. Such corporate investment arms are often anchor investors for startups companies as well as VC funds. To stimulate both the start-up community and the technology segment, we recommend FSTB to consider extending the exemption scope to this group of investors and to consider allowing such investment vehicles to set-off the losses (derived from investing in early stage companies) against passive income tax.

Summary

The proposals for a refined FSIE is greatly appreciated and comes with much of the flexibility necessary to continue to attract private equity and venture capital practitioners to operate in Hong Kong. We have highlighted above a few areas where the proposals fall short of options offered, for your consideration.

We are at your disposal should you wish to discuss further as you finalize the Guidelines.

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Yours sincerely

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Chair of HKVCA Technical Committee

About HKVCA

HKVCA is a member-based trade association which was established in Hong Kong in 1987. It currently has 480 members of whom 300 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 the world's 10 largest private equity firms.

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