

## Tax Newsflash



### Hong Kong Tax News

## The Inland Revenue Department Issues Guidance on Extended Offshore Funds Law

The Inland Revenue Department (IRD) issued Departmental Interpretation and Practice Notes No. 51 ("**DIPN 51**") to clarify the provisions of Inland Revenue (Amendment) (No. 2) Ordinance 2015 (the "**2015 Ordinance**"), which extends profits tax exemption under the Revenue (Profits Tax Exemption for Offshore Funds) Ordinance 2006 (the "**2006 Ordinance**") to non-resident private equity (**PE**) funds. The 2006 Ordinance and 2015 Ordinance are collectively referred to hereinafter as the "**Offshore Funds Law**". DIPN 51 is also significant as the IRD has, for the first time, published its position on carried interest. This will have far-reaching consequences to the PE fund industry in Hong Kong.

The IRD has also made changes to Departmental Interpretation and Practice Notes No. 43, which sets out the IRD's views on the 2006 Ordinance, in order to align it with the provisions of the 2015 Ordinance.

In this Tax Newsflash, we provide our initial observations on the key issues addressed in DIPN 51. For details on the 2015 Ordinance, please refer to [Tax Analysis](#). We will also provide detailed observations on DIPN 51 in an upcoming Tax Analysis.

### ***Excepted private company***

A transactions in securities of or issued by an “excepted private company” is a tax-exempt specified transaction.

- 1) **A "transaction" in an excepted private company should be taken to mean a disposition transaction.** DIPN 51 clarifies this in the context of discussing the three-year time frame of determining whether a company meets the various conditions to constitute an excepted private company.
- 2) **Aggregate value of an excepted private company determined.** In calculating the value of the assets of a private company to determine whether it constitutes an excepted private company, the value of its total assets and the value of its underlying Hong Kong portfolio companies or Hong Kong immovable properties would be considered at gross; liabilities would not be deducted. Further, the market value of the assets of the company should be considered in determining whether it constitutes an excepted private company.
- 3) **A PE fund will be exempt on gains arising from transactions in an excepted private company that eventually lists.** Conversely, the PE fund would also be tax exempt on gains on disposal of a listed company that subsequently privatizes and meets the conditions to be an excepted private company. However, DIPN 51 is not explicit on whether an SPV holding and administering an excepted private company should be entitled to HKPT exemption on the two scenarios above, although the same treatment would reasonably be expected.
- 4) **Transaction in securities may include transactions in a "private company" that does not meet the definition of an excepted private company or special purpose vehicle (SPV).** DIPN 51 provides that if the private company, under the relevant laws of its place of incorporation (e.g. the Companies Ordinance, if the company is incorporate in Hong Kong), is allowed to issue invitations to the public to subscribe for any shares or debentures of the company, the company would not be considered as a "private company" for the purpose of the Offshore Funds Law. This implies that a transaction in such a "private company", even if it does not meet the definition of "excepted private company" or "SPV") would also potentially be exempt from HKPT.

### ***SPV***

HKPT exemption will be available to a qualifying SPV in respect of profits derived from transactions in certain securities of or issued by another interposed qualifying SPV or an excepted private company. One of the key conditions for the SPV to qualify for such an exemption is that it be established solely for the purpose of holding and administering one or more excepted private companies.

- 1) **Purpose of establishment of an SPV solely for the purpose of holding and administering excepted private company(ies).** DIPN 51 implies that this purpose has to be present at the outset and throughout the lifetime of the company, as illustrated in an example whereby a fund establishes a company for the purpose of holding Hong Kong properties initially, but uses the company for holding an excepted private company after the Hong Kong properties are disposed of. In this case, the IRD stated that the company does not qualify as an SPV under the Offshore Funds Law.
- 2) **Limited functions of an SPV.** In order to meet the condition for being established solely for the purpose of holding and administering one or more excepted private companies, an SPV's activities in the "administering" of its underlying excepted private companies are limited to: the review of their financial statements, attendance of their shareholders' meetings, opening bank accounts for the collection of dividends or investment receipts, appointing company secretary and auditor. The SPV should not engage in active business such as trading, provide services to the PE fund (or any other party) and derive service fees, or be engaged in the management or maintenance and administration of the business of excepted private companies.

In determining whether to issue a certificate of tax residence (COR) to the SPV, the IRD mentioned in DIPN 51 that it will consider whether substantial business activities are carried out in Hong Kong and in this regard, cites two specific factors - whether the SPV has a permanent office in Hong Kong, or employs staff in Hong Kong to hold and administer the excepted private company(ies). However, even if the IRD were to issue a COR to the SPV, it remains to be seen whether the treaty partners of Hong Kong will consider the SPV to have sufficient business substance to qualify for treaty benefits, if the SPV's business activities are limited to those outlined above.

### ***Qualifying funds***

A non-resident PE fund that is not managed by a person licensed under the Securities and Futures Ordinance may enjoy the profits tax exemption if it is a qualifying fund; i.e. it has at least five investors (aside from its originators and their associates) whose capital

commitments exceed 90% of the fund's aggregate capital commitments and who receive at least 70% of the fund's net proceeds.

**Feeder funds to a master fund may be looked through, or parallel funds may be aggregated with a main fund in determining the number of investors of the master fund/main fund.** Some fund structures have feeder funds through which investors invest in a master fund or parallel funds alongside a main fund. Singularly, the master/main fund may not have sufficient investors to meet the conditions to be a qualifying fund. For the purpose of determining whether the feeder funds or parallel funds will be looked through or aggregated, such that their investors will be taken into account in determining whether the master/main fund would qualify as a "qualifying fund", factors such as the constitutive documents of the funds, investment mandate of the funds, management agreements etc. will be considered in totality. From the examples cited in DIPN 51, it would seem that if the feeder funds or parallel funds have the same investment mandate as the master/main fund, do not have independent existence on their own, and are established purely to address the needs of different investors who wish to invest into the master/main fund, the feeder funds or parallel funds could be looked through or aggregated.

### ***Deeming provisions***

**The numerical threshold for a "bona fide widely held" fund remains unchanged.** The numerical thresholds for what constitutes a "bona fide widely held" fund (50 or more investors; 21 or more of whom hold 75% or more of the income or property of the fund) will equally apply to a PE fund. This will be the case even if the PE fund has sovereign wealth funds, pension funds, central banks and/or government agencies as its investors. As long as the investor in question has a different investment mandate as the PE fund, it will be counted as one investor for the purpose of determining whether the PE fund is "bona fide widely held".

### ***Tax treatment of carried interest***

**Carried interest is considered as a service fee/employment income and potentially subject to Hong Kong tax.** The IRD has clearly stated its position that carried interest could be in the nature of a service fee or employment income in DIPN 51, and will apply the general anti-avoidance provisions of the Inland Revenue Ordinance (IRO) on carried interest arrangements if the carried interest is disguised as investment return.

The IRD provides in DIPN 51 that in determining the remuneration of the Hong Kong sub-manager/investment advisor, its functions, assets and risks should be assessed. The IRD reiterates in DIPN 51 that it does not likely consider a cost plus basis of remuneration to be

an arm's length rate, and, applying the general anti-avoidance provisions of the IRO, carried interest may be attributed to the services rendered by the Hong Kong sub-manager/investment advisor in Hong Kong and subject to HKPT. This is unless the return is an arm's length return on genuine investment; that is, the return is on the same investments as investments made by external investors, the level of returns and terms governing the returns are "reasonably comparable" to the returns and terms for the PE fund's external investors.

Carried interest received by fund executives who provide services in Hong Kong by way of distributions from the PE fund's general partner or carried interest partner may also be caught by the general anti-avoidance provisions and subject to Hong Kong tax as employment income or service fee.

Deloitte can assist you in performing an impact assessment of DIPN 51 to your Hong Kong tax positions, on matters such as whether your fund can benefit from the Offshore Funds Law, whether your investment holding company can qualify as a SPV for the purpose of the Offshore Funds Law, and if and how your carried interest plans will be affected.

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