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New practice note explains how IRD will interpret the new law exempting PE funds from tax

Useful guidance provided, but certain issues e.g., the permitted activities for SPVs and the tainting effect may need further clarification

The Inland Revenue Department (IRD) has just issued a Departmental Practice Note No. 51 (DIPN 51) stating how it will interpret certain provisions of the new law which extended the profits tax exemption for non-resident or offshore funds to cover private equity (PE) funds effective 1 April 2015.[1]

Under the new law, the definition of "securities" is amended to include shares, and other securities such as debentures and notes issued by certain overseas private companies, referred to as excepted private companies (EPCs), or issued by a special purpose vehicle (SPV). As such, the new law will cover and exempt most transactions undertaken by a PE fund, provided that other relevant exemption conditions are satisfied.[2]

Furthermore, if a PE fund is a qualifying fund, it will not be required to engage persons licensed by the Securities and Futures Commission to conduct transactions on its behalf in order to obtain the tax exemption.

The new law also allows a PE fund to employ an SPV to hold and administer its investment in EPCs. Any gains made by the SPV from its disposal of EPCs, or of another SPV, will also be exempt from profits tax, provided that other relevant exemption conditions are satisfied.

The IRD considers that "cost plus" formulas to compensate Hong Kong investment managers or advisors are not likely to be arm's length when significant functions have been performed or considerable risks have been borne in Hong Kong.

For the first time, the IRD has publicly stated its views on the "carried interest" arrangement commonly adopted by the fund management industry by way of a practice note.

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1. The IRD has also updated DIPN 43 ("Profits Tax Exemption for Offshore Funds") to reflect the legislative changes made by the new law.
2. For more details of the new law, please refer to our Hong Kong Tax alert on 17 July 2015 (2015 Issue No. 13).

Salient points of the DIPN 51 are discussed below.

Methods used to calculate the 10% restricted asset threshold of an EPC

In determining whether a portfolio investment in a private company made by a PE fund is an EPC as defined in the new law, there is a three-year look-back period commencing from the date of disposal of the private company concerned.

At all times within this look-back period, the aggregate value of certain restricted assets cannot exceed 10% of the value of the total assets owned by the private company, otherwise the private company will not qualify as an EPC. For this purpose, the IRD will interpret "value" as meaning the market value of the asset at the relevant times. For example, if the private company's investment in another private company is a restricted asset, the IRD will take the "market value" rather than the "par value" or "nominal value" of the share capital of the other private company into account.

Furthermore, in calculating the value of the total assets of the private company, debts of the private company including liabilities secured by mortgages on the relevant restricted assets owned are not to be deducted. Thus the values used in the percentage calculation are the gross amounts.

For the purpose of determining the values of the relevant assets, the IRD will examine the audited financial statements of the relevant EPC covering the last three years, supplemented by management accounts up to the date of the disposal of the EPC.

EY observations

Whilst the method used to calculate the 10% threshold has now been clarified, in practice it may be difficult for PE funds to forecast with sufficient certainty at the time a portfolio investment is made, whether that investment might become a restricted investment in the future (i.e., an acquired portfolio may subsequently breach the relevant 10% threshold test).

This is particularly the case for PE funds that acquire less than 100% stake in a portfolio, as is very often the case with PE investments. In this case, and especially if the fund does not own a controlling stake in the EPCs, it may be difficult to have sufficient influence over the activities and subsequent choice of investments by the EPC/portfolio investment concerned. Furthermore, asset valuations can fluctuate over time and the timing of exits may be hard to predict thereby rendering it difficult to ensure that the 10% threshold is met throughout the three-year look-back period. The implications for failing the 10% threshold test can however be very significant due to the risk, and the view taken by the IRD, that one non-qualifying investment will taint the whole fund (see discussion below).

Approach to determining the "at least five investors" requirement for a qualifying fund

For the purposes of determining whether a PE fund is a qualifying fund, an "investor" is defined to mean a person, other than the originator or the originator's associates, who makes a capital commitment to the fund. The "originator" means a person who directly or indirectly originates or sponsors the fund; and has the power to make investment decisions on behalf of the fund. In the context of a limited partnership structure, generally the "investors" are the limited partners and the "originator" is the general partner.

Feeder fund structure

DIPN 51 notes that feeder funds are often vehicles set up to cater for the specific needs of the investors, the funds themselves perhaps may not have independent existence. To determine whether it is appropriate to look through the feeder vehicle when counting the number of investors, the totality of the facts including the constitutive documents would be examined. By way of illustration, Example 7 of DIPN 51 indicates that where feeder funds are set up purely to address the needs of investors from different jurisdictions for investment into a particular fund, it would generally be appropriate to see through the feeders when counting the number of investors.

Parallel fund structure

Example 6 of DIPN 51 indicates that where the fund agreement of each parallel fund is substantially the same as the main fund, subject to modifications for regulatory, tax, structuring or other reasons; and where the size of the main fund and the parallel funds are aggregated for the purposes of any overall fund size capitalization, and investors in the fund and the parallel funds are generally aggregated for purposes of voting under the fund agreement, the main fund and the parallel funds should be looked upon as a single fund.

As such, Example 6 appears to indicate that under this fact pattern the "investors" of the main fund and the parallel funds would be aggregated for the purpose of determining whether the "at least five investors" requirement for a qualifying fund was met.

A large pension fund generally counts as a single investor

In contrast, DIPN 51 indicates that large pension funds are likely to operate with great independence from their participants and beneficiaries, the latter having no direct or indirect influence over the management of investments by the pension funds.

As such, where such a pension fund makes an investment in another fund, said pension fund would be counted as a single investor in that other fund.

EY observations

The example and the guidelines laid down in DIPN 51 for determining whether the IRD will see through a feeder vehicle when counting the number of investors should in general give industry players a good indication of the outcome of the majority of their cases. In case of doubt, seeking an advance ruling from the IRD may be desirable.

Activities an SPV can undertake if it is to qualify as an SPV

Section 20ACA(1) exempts an SPV from payment of tax in respect of assessable profits arising from the SPV's transactions in EPCs or another SPV (i.e., the interposed SPV which is also an SPV itself). The amount of the profits exempted corresponds to the percentage of shares or interests of the SPV that are held by an offshore fund.

DIPN 51 indicates that the SPV is not allowed to carry on any trade or activities other than for the purpose of holding, directly or indirectly, and administering one or more EPCs. That is, the SPV is to hold and administer EPCs in the capacity of a shareholder or a holder of a participation or equity interest. The "holding" and "administering" of an EPC can be direct or through other persons. However, the SPV cannot be involved in the management, maintenance and administration of the business of an EPC.

Based on the IRD's above interpretation, the activities of the SPV are restricted to: the review of financial statements of EPCs normally made available to shareholders or investors; attending the shareholders' meetings of EPCs; opening bank accounts for collection of dividends or investment receipts; and appointing a company secretary and auditor.

EY observations

Precluding the SPV from being involved in the management, maintenance and administration of the business of EPCs seems to be at odds with DIPN 51's recognition that a PE fund generally has to work with "the management team of the private company to improve performance and strategic direction, making complimentary investments and driving operational improvement."

As such, it would be helpful if the IRD can confirm that involvement in the management, maintenance and administration of the business of EPCs at the PE fund level, will not be attributed to the SPV concerned.

Tax residence of SPV

DIPN 51 states that given that an SPV is only an investment vehicle and that the operation of the SPV is restricted, the place of residence of the SPV generally follows that of the non-resident PE fund, regardless that the SPV might be incorporated or registered in Hong Kong.

In deciding whether a certificate of Hong Kong tax residence can be issued to the SPV for the purposes of facilitating the SPV to claim tax treaty benefits, the IRD would consider whether the SPV has substantial business activities in Hong Kong such as whether the SPV has a permanent office or employs staff in Hong Kong to hold and administer its investment in EPCs.

EY observations

The restrictive view of the IRD regarding the activities that can be undertaken by an SPV and the comments that "the place of residence of an SPV generally follows that of the non-resident PE fund", seem to imply that it may be difficult to obtain a certificate of Hong Kong tax residence for an SPV. This seems to be inconsistent with the apparent original intention of allowing an SPV to be a Hong Kong incorporated company such that the SPV can qualify as a Hong Kong resident for tax treaty purposes.

An EPC subsequently sold as a listed company (or vice versa) will still be a qualifying transaction

Depending on the market conditions, an offshore PE fund may sell its investment in an EPC to another strategic investor or to the public through an initial public offering (IPO).

DIPN 51 states where a PE fund sells its investment in the EPC through an IPO, it is in substance no different from a transaction in listed securities or a transaction in securities of an EPC, both types of transactions qualifying as specified transactions exempt under section 20AC(1).

Conversely, if a listed company after privatization is sold as an EPC, the PE fund will also continue to be exempt from profits tax, provided that other relevant exemption conditions are met.

EY observations

Where a non-resident PE fund itself, i.e., not through an SPV, sold what was originally an EPC as a listed company through an IPO (or vice versa), it appears to be clear that the PE fund would qualify for the profits tax exemption in respect of the said transaction under section 20AC(1). This is the case, given that transactions in listed securities and EPCs now both fall within the definition of "securities" under the new law.

The uncertainties of the tax consequences of selling an original EPC as a listed company through an IPO (or vice versa) may apply more to the situation where such a transaction is undertaken by an SPV. This is because under the new law, the SPV is only allowed to hold and administer an EPC but not a listed company, if the SPV is to be eligible for the tax exemption under section 20ACA (1).

As such, the above views expressed by the IRD under the heading "Special Purpose Vehicle" in DIPN 51 appear to be intended to also apply to the situation where the relevant transaction is undertaken by an SPV.

A non-qualifying transaction undertaken by a PE fund will taint all other qualifying transactions by the PE fund

DIPN 51 illustrates the tainting effect by way of following quoted passage. "For example, an offshore private equity fund invests in a number of overseas private companies, one of which is carrying on business or holding an immovable property in Hong Kong (i.e., only one overseas private company fails to qualify as an excepted private company). Transacting in the securities of that overseas private company will taint the investments in other overseas private companies. Clearly, the offshore private equity fund is not eligible for profits tax exemption under section 20AC."

EY observations

Given that eligibility for the tax exemption under section 20AC is to be determined on a year by year basis, it appears that the tainting effect would likewise have to be determined on a year by year basis, albeit the above quoted passage in DIPN 51 does not explicitly say so.

It however remains unclear whether a non-qualifying transaction undertaken by an SPV would taint all other qualifying transactions undertaken by other SPVs of a PE fund, DIPN 51 making no mention of such a situation.

We would welcome the IRD's clarification on the above points.

No relaxation of the "bona fide widely held" test for PE funds

Where a Hong Kong resident owns an interest of 30% or more in an exempt offshore fund and the offshore fund is not "bona fide widely held", the Hong Kong resident will be deemed to have derived a proportional share of the assessable profits of the fund and be taxed accordingly.

The term "bona fide widely held" is however not defined. As a matter of assessing practice, before the tax exemption regime for offshore funds was extended to PE funds effective from 1 April 2015, one of the conditions for the IRD to regard a non-PE fund to be "bona fide widely held" was that the relevant fund had 50 investors or more.

Given that a typical PE fund is unlikely to have 50 investors or more, some commentators have expressed the view that a separate set of criteria for determining what constitutes a '"bona fide widely held" PE fund may be warranted. DIPN 51 however states that the '"bona fide widely held" test applies to all offshore funds though private equity funds by their nature are unlikely to be widely held.'

EY observations

It may be difficult for many PE funds to meet the test requiring "no fewer than 50 investors" and "no fewer than 21 persons holding 75% or more of the fund". As such, the bona fide widely held provision may in practice be of limited assistance. If an offshore PE Fund fails to meet this test, it will only be bona fide widely held if the IRD is satisfied that it was established with a view to wide public participation and genuine efforts were taken to achieve that objective.

Compensation on a cost-plus basis unlikely to be arm's length in nature

Typically, the offshore lead investment manager may appoint a Hong Kong based investment manager or advisor to arrange and conduct investments through or from Hong Kong.

In this regard, DIPN 51 states that the Hong Kong "investment managers and advisors should be adequately compensated for their services or remunerated on an arm's length basis. Management and performance fees based on a cost-plus formula are not likely to have been determined on the arm's length basis, in particular when the investment managers or advisors performed significant functions and bore considerable risks in Hong Kong to generate the profits of the offshore funds."

EY observations

Given the IRD's above stated position, it would be advisable to perform a transfer pricing study on the fees paid by the offshore lead investment manager to the Hong Kong investment manager or advisor. The study should include an analysis on the operations of all management entities relevant to Hong Kong. Particular care should be made to identify the key functions that are core to the generation of the profits accruing to the offshore funds, including the investment management decision-making process (a "functional analysis"). Importantly, the analysis should also identify who performs these functions and the degree to which the functions are performed in Hong Kong.

This analysis will also impact the carried interest analysis, below refers.

General anti-avoidance provisions may be invoked to charge "carried interest" to tax in Hong Kong

In DIPN 51 the IRD express the view that as a standard industry pay formula, the offshore lead investment manager of a fund may take 2% of the fund's asset each year as a management fee, and a further 20% of the profits above a hurdle rate as a kind of performance fee often described as "carried interest".

DIPN 51 further notes that the "carried interest" may not under certain arrangements be received as performance fees, but rather be received as an investment return relating to an offshore lead investment manager's separate equity interest in a fund that they manage, i.e., as a distribution by the fund to them in their capacity as an investor rather than as a service provider.

The IRD state they will apply the general anti-avoidance provisions of the Inland Revenue Ordinance and attribute to the Hong Kong investment manager or advisor: (a) the income accrued to the lead investment manager; or (b) distributions received by the general partner in cases where the IRD considers that the Hong Kong company is not adequately remunerated in light of the functions, assets and risks of the Hong Kong operations.

In such circumstances, DIPN 51 further notes that the executives or other service providers of the Hong Kong investment manager or advisor may not receive their remuneration as remuneration, but rather as investment returns relating to their separate equity interests in the offshore fund or in the offshore lead investment manager company.

In this regard, the IRD states that the above approach of applying the general anti-avoidance provisions to charge the Hong Kong investment manager or advisor to tax in Hong Kong would similarly apply to charge the executives or other service providers of the Hong Kong investment manager or advisor to either Salaries Tax or Profits Tax in Hong Kong as the case may be.

EY observations

As noted above, a transfer pricing study including a functional analysis is recommended to help assess the carried interest position. Given the IRD's above stated position, this will help assess whether the Hong Kong investment manager or advisor is "adequately remunerated for its services after considering the functions, assets and risks" attributed to the Hong Kong operations. Furthermore, the Hong Kong investment manager or advisor should also review the remuneration arrangements for their executives and other service providers to determine whether any "carried interest" arrangement can be justified as investment returns based on the particular facts of the case. Where the "carried interest" arrangement cannot be so justified, there may be penal issues to consider for the under-reporting of income by the employer and employee concerned.

Overall commentary

We welcome the IRD's clarification of how it will interpret certain provisions of the new law. However, it appears that the permitted scope of activities for SPVs may be too restrictive. It is also unclear whether, if not the SPV concerned, the PE fund itself can be involved in the business operations of an EPC.

More clarifications by the IRD on the extent of the tainting effect, in particular whether one non-qualifying transaction undertaken by an SPV would taint other qualifying transactions undertaken by other SPVs of a PE fund may be required.

How the new law is to be interpreted and views stated by the IRD in DIPN 51 including those on "carried interest" arrangements would have significant impacts on the operations of a PE fund. These issues could be complicated in certain circumstances. Clients should seek professional tax advice where necessary.

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