HK私投募資VCA

HKVCA response to FSTB Consultation on Ring-fencing

Private Equity and 'ring-fencing'

HKVCA has recommended, for some years, that Hong Kong should amend existing legislation that inhibits Private Equity Funds and Private Equity Managers from operating (and becoming resident) in Hong Kong. The onshoring of Private Equity Funds and Managers in Hong Kong will cement Hong Kong's current position as the largest cross-border centre for Private Equity in Asia – and create more high-value jobs in Hong Kong. Failure to change the legal current status quo will result in an increase in Private Equity firms establishing onshore structures elsewhere in Asia.

The concept of 'ring-fencing' has been troublesome to this 'onshore' concept – and the aggressive and unreasonable position set out in IRD's DIPN 51 has actually negated much of the worthwhile provisions introduced in the 2015 extension of Offshore Funds Tax Exemption.

Of greater importance to Hong Kong's role in the Private Equity sector's development is the requested introduction of an updated Limited Partnership law in Hong Kong. Awkward 'ring-fencing' provisions around the investments a Hong Kong-based Limited Partnership might make in Hong Kong companies (or non-Hong Kong companies with some Hong Kong operations) will eliminate the benefits of trying to implement this legislation. Failure to get a Hong Kong Limited Partnership right, will result in Hong Kong's lead in cross-border Private Equity being gradually diminished.

Comments provided in this Response should be read in the context of the 2015 extension of Offshore Funds Tax Exemption **and** the proposal to create a new Hong Kong Limited Partnership fund vehicle.

The preferred legal structure for Private Equity Funds is a Limited Partnership which is typically transparent for tax purposes: the investors, known as Limited Partners, are responsible for paying tax on any gains created by the Fund in the jurisdiction where they are resident. With the fund vehicle being merely a convenient way of bringing investors into one investing entity, limitations on the scope of investment strategy or potential future tax traps

for the Fund will result in Private Equity firms relocating activities to jurisdictions that do not constrain investment strategy or create potential future tax liabilities on the Fund vehicle.

In many countries Private Equity, and its Venture Capital subset, are seen as generally beneficial actors who commit growth equity capital to commercial enterprises and start-ups that allow these businesses to grow more rapidly, to expand operations and hire more people. In Hong Kong the Government is seeking to support Innovation and Technology growth by encouraging Venture Capital investments into early stage companies. 'Ring-fencing' is a direct contradiction of this initiative.

HKVCA has, for the reasons given above, been opposed to the way in which 'ring-fencing' provisions have been applied to date towards Private Equity activities. We argued strongly that the 'ring-fencing' provisions in DIPN 51 were unnecessary and destroyed the benefits provided in the 2015 extension of the Offshore Funds rule. HKVCA strongly supports the removal of 'ring-fencing' features in past and future legislation that applies to Private Equity activities.

An initiative to undo the 'ring-fencing' provisions in Private Equity legislation that uses opaque and unclear wording and difficult-to-assess future hurdles and unreasonable timeframes/holding periods will convince an already sceptical Private Equity industry that the Hong Kong government is not serious about maintaining Hong Kong's position in the face of changing cross-border investment dynamics.

The FSTB Consultation paper, as written, outlines measures that are unclear and a create uncertainties that are a deterrent for use by bona fide Private Equity investors – and will likely lead to an acceleration of Private Equity activities away from Hong Kong.

Remove 'ring-fencing' provisions & apply sensible anti-abuse measures

By encouraging the development of Hong Kong-based Fund vehicles, that are essentially free from tax, clearly raises some concerns. Financial Services Development Council Paper 17 on Limited Partnerships for Private Equity Funds, and the follow-up FSDC Paper 32, addresses many of these concerns and suggests that the need for 'ring-fencing' is eliminated by a combination of measures: minimum percentages of offshore capital in the Fund, regulatory oversight of Managers' activities, exclusion of real estate-heavy investments and the application of Hong Kong tax rules on any investments these Funds make into Hong Kong businesses.

Comments on FSTB Consultation paper on removing Ring-Fencing Features

We have been asked to provide HKVCA's view on FSTB's 4 April 2018 paper – and have the following comments on this paper:

- The Consultation document makes a significant re-definition of an eligible entity from earlier being a 'person' to now being a 'fund'. There are important implications in this change where, in the real world, a 'fund' comes in many shapes, sizes, structures and degrees of complexity. To illustrate this point, 'Funds of One' (often pension funds or sovereign investors) may represent thousands of underlying investors and may invest alongside a 'China Fund' (which might employ its own managers, based in Hong Kong). To maintain its position as the largest centre for cross-border Private Equity in Asia, Hong Kong may need to offer flexibility in the definition of a 'fund' for instance by offering a prior approval service for confirming 'fund' status on an investment entity.

- Throughout the paper there is reference to fund investments. It should be noted that rarely do funds invest directly into underlying operational companies. A fund will often invest through one or more intermediary vehicles (often known as 'special purpose vehicles' or SPVs), sometimes with parallel fund vehicles and feeder funds. It should be clarified that these intermediary vehicles will receive all the rights that apply to the fund that owns the SPV.

Going through the Consultation paper by reference to specific paragraphs:

Para 6&7. It is important that any Fund or Manager that has used the pre-existing tax exemption is not disadvantaged. An application process for IRD clearance for any affected firms would ease concerns for any Private Equity investors that have established Managers in Hong Kong following the 2015 legislation.

Para 6. Note 6. 'the number of investors exceeds four' does not take account of pension fund or sovereign investment funds that clearly represent many underlying investors. Hong Kong's attractiveness as a Private Equity centre is considerably enhanced if pension funds and sovereign investors continue to expand here. Again, an advance clearance process could solve this issue.

Para 9. There is benefit in both small funds providing Venture Capital type investments

and also in large funds engaged in buyout transactions. It makes no sense to exclude a fund on grounds of size.

Para 10. A 'fund' should be exempt from tax on returns from qualified investments. Any returns on non-qualified investment should be subject to Hong Kong tax (at the level of returns received by Hong Kong tax payers). The current wording is confusing.

Para 11. The list of eligible asset classes outlined in this paragraph covers many of the types of investment that a Private Equity investor might make. There are however other asset classes that have a claim for eligibility (such as wine/art/cars, offshore real estate, income from bonds/debentures).

Para 12. The current drafting of this paragraph is highly troublesome for Private Equity firms – and the impossible-to-forecast future assessments contained here make the entire scheme potentially commercially unviable.

Para 12(a). The proposed threshold of less than 10% of assets in HK immovable property is low but unlikely to cause Private Equity firms a problem at the time of investment – but does give rise to impossible-to-forecast exposure if the value of Hong Kong property grows rapidly. The definition of 'immovable property' is broad: this could catch investments in infrastructure assets under Belt and Road investment strategies. Presumably the sensitive asset class is 'residential property' not immovable property being utilised in the course of the company's (non-property) business.

Para 12(b). Holding an investment for more than 5 years is unrealistic. We have shared with you (in January 2018) the statistics for Private Equity holding periods in Asia:

Asian PE & VC investment holding periods	Last 10 years
Average Holding Period	4.51 yrs
Less than 36 months	28.6%
Less than 24 months	14.8%

Source: HKVCA Research

If it is necessary to stipulate a minimum holding period to eliminate 'trading' activity from these measures – then a holding period of two years or longer would be reasonable (and note that 3 years could be considered a real commercial risk at nearly 30% of all investments).

Para 12(c). The current wording in the Consultation paper constitutes a substantial commercial risk for potential investors and possible 'ring-fencing' of certain industry sectors and gives rise to impossible-to-forecast risks that will deter Private Equity investment. Any impact beyond an initial two year period will act as a meaningful deterrent to using legislation governed by these terms.

Para 13 tainting. Tainting makes no sense in a portfolio of 'fund' investments and should be completely removed.

Para 13 HK tax. If a 'fund' invests in a Hong Kong entity that fails to pass the test of 12(a) and 12(b) above – then the 'fund' (or its investors) should be liable for Hong Kong Tax on any gains on that investment. A Private Equity investment is generally held for a medium to long term and qualifies in most jurisdictions as a capital gain. In Hong Kong the assessment of a fund making a capital gain is not clearly defined. HKVCA believes that a Private Equity investment held for 2 years or longer should be treated as a capital gain (this is the principal test used for Capital Gains in Singapore).

Para 15. Hong Kong is the only major international financial centre that states it taxes Carried Interest as Income. This position has been justified by IRD based on using General Anti Avoidance Provisions (GAAP). It is worth noting that GAAP is available in all other major financial centres – which have chosen not to use GAAP to tax Carried Interest as Income.

HKVCA believes that Carried Interest is a complicated subject, where certain incentive schemes in Hong Kong may have been mis-labelled as Carried Interest. IRD may have formed its views on Carried Interest based on its investigations – and may not understand that many schemes have been designed to properly create the attributes of capital gains. There is an urgent need to have a full discussion with FSTB and IRD on whether Hong Kong intends to formalise the most aggressive anti-Carried Interest stance of any major financial centre.

Summary

HKVCA has requested changes to legislation around Private Equity Funds and Managers being able to operate onshore in Hong Kong. There is no loss of tax income implicit in this request, but by making Hong Kong more attractive to the enhanced physical presence of Funds and Managers, this initiative would lead to the creation of additional high-value jobs and growth in Hong Kong's leadership in this sector.

Private Equity, as a definition of investment activities, includes Venture Capital and Infrastructure investments. Failure to prepare legislation that enables usable operating conditions will result in (i) Venture Capital being discouraged from operating in Hong Kong and therefore less capable of supporting the Government's Innovation and Technology plans and (ii) will jeopardise Hong Kong's position as a base for Belt and Road supporting infrastructure funds.

The 2015 legislation was helpful to encourage Private Equity firms to upgrade Advisory operations in Hong Kong to Manager status, but was rendered commercially unviable (for all but a very few specialist firms) by the conditions in DIPN 51. The removal of 'ring-fencing' as set out in this Consultation paper with poor drafting, unrealistic timescales and the uncertainty of future tests on wide-defined asset percentages will not change Private Equity firms' assessment – that the Government is not serious about retaining and attracting Private Equity activity in Hong Kong.

The trend embodied by OECD's BEPS initiative is encouraging legal structures where the Management Operations and Fund Legal Domicile are located in one place. Unless the dropping of 'ring-fencing' contains more commercially-viable terms – that are then rolled into new Limited Partnership vehicles in Hong Kong – there will be pressure on Private Equity firms to relocate activities away from Hong Kong to a jurisdiction which allows sensible commercial investment activities through a Manager and Fund in one place together with a good network of Double Tax Treaties. Hong Kong – as the pre-eminent cross-border Private Equity centre in Asia – can gain from the pressure on 'offshore' centres, but will lose business if it does not improve its legislation.

The changes proposed in the Consultation paper do not go far enough to remove measures that conflict with the way in which Private Equity firms naturally operate. Hong Kong will lose business if it places unreasonable constraints on holding periods and investment strategies.

Eric Mason 2/5/2018
Chairman, HKVCA

About HKVCA

HKVCA is a member-based trade association which was established in Hong Kong in 1987 currently with over 400 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 9 of the 10 largest global private equity firms.