Hong Kong Venture Capital & Private Equity Association
Room 2001, Wilson House
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24/F Central Government Offices
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Sent via email

Proposed Extension of Profits Tax Exemption to Onshore Privately Offered Open-Ended Fund Companies

In response to your request for inputs in your letter of 9 March 2017, the Hong Kong Venture Capital & Private Equity Association (HKVCA) has the following comments on the Proposed Tax Exemption.

HKVCA is very supportive of the Government's initiatives in developing an onshore OFC regime for fund managers. Such a regime should complement the other fund platforms that are commonly used by the fund management industry in Asia and should enhance Hong Kong's position as the premier fund management centre in Asia. However, the framework of the OFC regime needs to be one that the industry believes would be attractive enough in order to encourage asset managers to consider using a Hong Kong domiciled fund over the existing typical fund structures.

1. In Asia, the Private Equity industry principally uses Limited Partnerships rather than Open-Ended Fund Companies (OFCs). Over time some Private Equity funds could consider using an OFC, but Investors and Managers typically would prefer a partnership fund vehicle over a corporate entity. A review of the Hong Kong Limited Partnership regime would therefore be of particular interest to the Private Equity industry.

2. The concept of bringing Fund entities onshore in Hong Kong, however, is strongly supported by the Private Equity industry. All the arguments that apply to asset managers who utilize OFCs for their fund entities apply to Private Equity managed Limited Partnerships. We believe onshore fund entities will strengthen and deepen Hong Kong's Private Equity sector.

3. The PE industry is actively monitoring the international developments with respect to the OECD's BEPS initiatives. The offshore fund jurisdictions have implemented the recommended tax transparency and exchange of information action points, and Hong Kong has also committed to this. It is therefore a good opportunity for Hong Kong to develop itself as an alternative location for establishing an onshore fund, given the focus that many other countries place on substance situated at the fund domicile location. In Asia, the interpretation of treaties for the avoidance of double taxation (DTAs) and the impending implications of OECD's BEPS initiatives may favour a fund location which combines an attractive physical base for fund managers, competitive taxation on the fund entity, sensible regulations and a good network of DTAs (with the principal investment destinations and the sources of investment capital).

4. Given that Private Equity funds typically utilize Limited Partnership structures as the fund vehicle, HKVCA would like any exemption benefit offered to asset managers who utilize OFCs, extended also to Limited Partnership vehicles with the minimum possible delay.

Whilst we do not seek to make any specific requests regarding the OFC conditions, we would like to put down some markers for possible future consideration of Limited Partnerships.

A. The 'not closely held' rules could be very difficult to comply with in practice due to Private Equity funds' sometimes small number of Investors and there are concerns about the implication to the fund if a 'qualifying' investor was no longer considered a qualifying investor during the life of the fund. These rules should therefore be reconsidered to ensure that they are workable in practice.

B. The benefit of having an onshore fund structure, supported in many cases by an onshore manager, is that the legal substance of the investment vehicle is based in Hong Kong. The fund manager is therefore able to manage the fund, and the SPVs established to hold investments, through the management and investment teams in Hong Kong. Currently, however, the IRD has made it extremely difficult for funds to obtain Tax Residence Certificates (TRCs) in these situations even when clearly the SPV or fund is managed and controlled in Hong Kong and therefore a tax resident for the purposes of Hong Kong tax law. For many purposes, this legal substance needs to be supported by a TRC issued by the Inland Revenue Department. If the principles governing the issue of a TRC are not clear and reasonable, then fund vehicles will not be created in Hong Kong.

C. Hong Kong is increasingly being used as the regional center for pension funds or sovereign wealth fund investment in Asia. These types of investor are very attractive for Hong Kong in that they build and strengthen the hub effect that makes Hong Kong so efficient in this sector. The fund legal entities may have only one shareholder/partner but represent the financial interests of thousands of individuals. Such investment vehicles should be encouraged and the qualifying rules adapted to include these investors.

D. Restrictions applied to the tax exemption which allows offshore Private Equity funds to be managed from Hong Kong have some serious drawbacks. If these restrictions are rolled-over into the onshore Limited Partnership vehicles, the attractiveness of Hong Kong as a fund domicile would not be high. The key issues are (1) that funds should be able to invest in HK-based companies and (2) any non-permissible investments would be taxable in Hong Kong, but would not cause the entire tax exemption of the fund to be lost.

E. There is an extreme position being expressed in paragraph 11(d) that "…such (performance) fees and (carried) interest are essentially income or profits" which would make Hong Kong the only major financial centre to categorise carried interest as income. There are real concerns that such a deeming rule would have a significant impact on the Private Equity industry in Hong Kong and the role of Hong Kong as an asset management centre. We believe that the law, that currently applies, adequately addresses the issues around carry and whether or not that carry is subject to tax either at the fund manager level or in the hands of the recipient. The true nature of carried interest is the same as the investment returns earned by other limited partner investors. The nature of carry is to align the interests of the investors with those of the manager and it is indeed a return on the investments made by the fund.

F. For Hong Kong to succeed as an onshore base for Private Equity funds it requires (1) an updated legal structure for Limited Partnerships, (2) a clear and competitive taxation of the fund, the manager and the management team, (3) a sensible regulation of the managers (rather than the fund entities) and (4) an improved network of DTAs.

We are supportive of FSTB's initiative to create Hong Kong based OFCs for asset managers – and trust that there will be a similar initiative for Hong Kong based Limited Partnerships. There is concern however that post-legislation interpretations imposed on the Extension of Offshore Funds Tax Exemption rendered this recent reform unattractive to most Private Equity firms and a similar restrictive approach, if applied to onshore Private Equity fund structures, would result in a low utilisation by our member firms.

We greatly appreciate your desire to assist asset managers by upgrading the structures for onshore funds, and thank you for offering us this opportunity to provide feedback.

Yours sincerely

John Levack
Vice Chairman