HONG KONG TAX ALERT

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IRD Issues Guidance on Extension of Offshore Funds Exemption to PE Funds

The Inland Revenue Department issued its Department Interpretation and Practice Note 51 on 31 May 2016 in which it outlines how it intends to interpret legislation introduced last year to extend the existing profits tax exemption for offshore funds to offshore private equity funds

Summary

- *DIPN 51 contains comments on the majority of issues that the PE industry has been working thorugh since the release of the legislation to extend the offshore funds exemption to PE funds last year*
- *DIPN 51 does not provide the clarity expected and also introduces a number of additional restrictions that had not previously been shared. This is unlikely to provide many PE funds with sufficient comfort to place reliance on the revised exemption*
- *DIPN 51 also contains comments on management fee and carried interest arrangements, and these comments are likely to create additional uncertainty as to how carried interest should be taxed in Hong Kong*

Hong Kong's Inland Revenue Department (IRD) has released a new Departmental Interpretation and Practice Note (DIPN 51) in which it outlines how it intends to interpret and apply legislation enacted in July 2015 (Inland Revenue (Amendment) (No. 2) Ordinance 2015, referred to hereafter as the July 2015 legislation) to extend the existing tax exemption to offshore private equity funds. At the same time, the IRD has updated its existing Departmental Interpretation and Practice Note (DIPN 43) in respect of the offshore funds exemption (the exemption) to reflect the changes contained in the July 2015 Legislation.

The PE industry in Hong Kong has been eagerly awaiting the DIPN issuance from the IRD. The legislation introduced last year contained a number of areas of uncertainty for offshore PE funds, leading to concerns that the uncertainties may prevent funds from being able to rely upon the extended exemption provided in the law.

The purpose of the July 2015 legislation is to exempt offshore PE funds from tax in Hong Kong in respect of investments outside of Hong Kong. This includes investment gains made by an SPV (whether established in Hong Kong or elsewhere) from the disposal of an offshore portfolio investment. This was expected to enable PE funds operating in Hong Kong to simplify their existing offshore/onshore operating models and potentially to provide scope for funds to establish a Hong Kong platform through which funds could hold their investments made in the PRC and elsewhere.

Although it is pleasing that the IRD has issued guidance on the application of the new PE fund exemption following the introduction of the July 2015 legislation, in many instances the level of clarity provided is insufficient and this will continue to create uncertainty over the application of the exemption to PE funds. This is not ideal given that one of the key benefits that was expected when the legislation was introduced was that it would promote Hong Kong's status as a fund management centre and lead to more fund management activity in Hong Kong generally.

Finally, the DIPN touches on the controversial subject of the taxation of carried interest distributions and the ability of a Hong Kong SPV to obtain a tax residency certificate from the IRD. We comment on each of these aspects below.

Key Interpretation Issues Contained in DIPN 51

Definition of 'Expected Private Company'

The key objective of the July 2015 legislation was to extend the scope of the exemption to cover investments in private companies that meet set qualifying conditions. To do so, the July 2015 legislation introduced the concept of an 'Excepted Private Company' (referred to as a 'Qualifying Private Company' for the remainder of this Tax Alert).

A Qualifying Private Company broadly refers to investments in offshore private companies, however a number of restrictions were also introduced to prevent direct or indirect investments in companies with substantial real estate or business operations in Hong Kong being covered by the extended exemption. Broadly speaking, where the Hong Kong real estate assets or shares in a company with business operations in Hong Kong do not represent more than 10 per cent of the value of the assets of the company making the investment at any point during the three years prior to the disposal of the investment, safe harbour rules apply and would enable the investment to be covered by the exemption. Relevant comments in the DIPN relating to this include:

- comments that the 'market value' of the relevant assets (i.e., shares in subsidiaries with a permanent establishment or real estate in HK, real estate in HK held directly by the Qualifying Private Company) should be used when measuring the application of the safe harbour thresholds. This is something that had not been specifically flagged in earlier discussions. Instead, the understanding was that safe harbour thresholds would be measured based on the carrying value of the assets in a company's financial statements.

  The DIPN does note that reference should be made to the company's financial statements to determine the market value of the assets. However, it is unclear what is required where the financial statements record assets at historical cost. Does historical cost become market value for the purpose of measuring the safe harbour thresholds or does a valuation need to be performed?

  DIPN 51 contains a number of comments, which suggest that IRD officials expect the safe harbour thresholds will be easy to measure with the calculations primarily being based on a company's financial statements. It also suggests that a valuation should not be needed but in the absence of a valuation, disputes could arise with regards to the true market value of the assets.

- there is no need to prepare special purpose financial statements up to the date of the disposal of an investment in order to measure the three-year period referred to above. Instead, reference can be made to the three most recently completed financial years prior to the disposal in order to determine whether or not the investment was made in a Qualifying Private Company.

Qualifying Fund

An important change contained in the July 2015 legislation was to relax the requirement that qualifying investments made by a PE fund needed to be made through or arranged by a person licensed with the Hong Kong Securities and Futures Commission (SFC). This is no longer necessary provided that the offshore fund is a 'qualifying fund'.

DIPN 51 clarifies that:

- it will generally be possible to look through a master feeder structure to determine whether the offshore fund has the minimum number of investors (five contributing at least 90 per cent of the committed capital of the fund at final close) in order to be designated as a qualifying fund. .

- investment vehicles established by foreign pension funds will generally not be able to satisfy the qualifying fund definition requirements unless there are other investors in the vehicle. This is because the IRD views the foreign pension fund as one investor when applying the qualifying fund definition rather than considering the beneficiaries of the pension fund as separate investors. In the absence of any other exemption applying to the pension fund, some may now look to obtain an SFC license in order to rely on the exemption in the future.

Special Purpose Vehicle

One of the key features of the July 2015 Legislation was the introduction of a new exemption to apply to investment gains realised by SPVs (including HK SPVs) that have been established by PE funds to hold portfolio investments. DIPN 51 contains a number of comments in relation to the application of the new SPV exemption including:

- reiterating that to be a qualifying SPV, an entity must be established for the sole purpose of holding and administering one or more qualifying private companies. This means that an existing company, which has previously undertaken other business activities but is now dormant would not qualify as an SPV for the purpose of the SPV exemption. It is difficult to understand why the IRD felt it was necessary to introduce such a restriction.

- that an SPV is unable to perform any activities except for the purpose of holding or administering investments in Qualifying Private Companies. The guidelines provide a very restrictive interpretation of the activities that could be performed by an SPV for the purpose of holding or administering an investment. If the SPV carries out functions beyond those stated in the guidelines, the entire exemption could be lost to the fund. In our view, an HK SPV should be able to undertake the necessary activities to 'manage' its investments. The board should at least be able to undertake all activities necessary to manage its investments without the risk of jeopardising its SPV status and not to do so potentially leaves the directors in breach of their fiduciary duties. However, the IRD has instead sought to limit the activities that can be performed by an SPV to:

  - reviewing financial statements of portfolio investment companies,

  - attending shareholder meetings of the portfolio investment companies,

  - opening bank accounts to enable the receipt of dividends and investment disposal proceeds,

  - appointing a company secretary and auditor.

This narrow interpretation is disappointing and will make it challenging for a Hong Kong SPV to obtain a Tax Residency Certificate from the IRD (see below). It can be inferred as a result that the IRD will not consider a Hong Kong SPV to have the necessary substance to be a tax resident of Hong Kong.

Listed Security Investments held by an SPV

A qualifying SPV is one that directly or indirectly holds one or more private companies. The guidelines do not address the scenario in which an SPV continues to hold an investment following an initial public offering. An IPO is a common exit strategy for PE funds and this can result in either a full disposal of the investment through the listing process or a partial disposal with the holding company continuing to retain a stake in the newly listed company following the IPO. Upon the IPO, the listed entity will cease to be a private company and arguably the requirements of the SPV exemption would no longer be satisfied as the activities of the SPV would no longer solely consist of holding and administering investments in Qualifying Private Companies.

We question whether this outcome would have been the policy intent as listed company investments were always covered by the original offshore fund exemption. However, the July 2015 Legislation, as drafted, makes it difficult to rule out this interpretation. Despite the fact that the IRD previously indicated that this was not the intended outcome, they have not made this clear in DIPN 51. The DIPN does indicate that a disposal of an investment by a PE Fund through an IPO would still be covered by the exemption but does not comment on a disposal made by an SPV or where the SPV continues to hold the investment. The fact that these comments are included under the SPV section of DIPN 51 may suggest that they should apply equally to an SPV, however the DIPN does not comment at all on a disposal made after an IPO (i.e., where the SPV retains a stake following the IPO and subequently disposes of it).

The comments contained in the DIPN are at best confusing and are unlikely to provide sufficient comfort to industry participants that gains made by an SPV on or following an IPO are covered by the SPV Exemption. As a result, there is a risk that a number of PE Funds will not seek to specifically rely on either the exemption or the SPV exemption given the significance of IPO strategy to their business models.

Alternative Business Structures

Another issue that is not addressed in the DIPN is the range of legal structures that an SPV may invest in aside from private companies. Common examples include investing into a Tokumei Kumiai (‘TK’) structure in Japan or a Managed Investment Trust (‘MIT’) in Australia. Both are common structures used for investing into those countries but neither a TK nor an MIT could be considered to be a private company. In addition, it it unlikely that a TK or MIT could be considered to be an SPV as the activities performed by these entites are typcially more extensive than the IRD’s list of activities that can be performed by an SPV. It is unclear why investment structures like these, which are commonly used by PE funds, should not fall within the scope of the SPV exemption.

Tainting of Qualifying Investments

The IRD has confirmed the long held view of practitioners that through making one non-qualifying investment, an otherwise eligible offshore fund would be unable to rely on the exemption for all other investments. It is disappointing that the IRD has not looked to adequately address this issue, which has been around since the original offshore fund exemption was introduced in 2003, but at least their position is now known and funds can look to put in place adequate measures to ringfence any non-qualifying investments.

Carried Interest

At the end of DIPN 51, the IRD has included comments on the taxation of investment managers, which readers will know has been a controversial issue in recent years as a result of a series of tax audits performed by the IRD in respect of offshore/onshore fund management structures (i.e. an offshore fund manager with a Hong Kong investment advisor). The key issue, through these tax audits, has been whether a greater proportion of the overall management fee received by an offshore fund manager should be paid to the Hong Kong investment advisor (and thus taxed in Hong Kong) to reflect the value of the activities performed by the employees of the Hong Kong investment advisor.

In addition, in many tax audits the IRD has looked to attribute a portion of carried interest paid by PE Funds to the Hong Kong investment advisor when determining the revised tax position of the advisor.

The comments in DIPN 51 make it clear that the IRD expects a Hong Kong investment manager or advisor to be adequately compensated and to receive an arm's length return for the services that it performs and that fees calculated using cost-plus formula are unlikely to be sufficient.

The IRD also reserves the right to use anti-avoidance provisions in order to tax carried interest in Hong Kong (either through assessing a Hong Kong investment advisor, the fund executives or whoever ultimately receive a portion of the carried interest) unless the carried interest represents an arm's length return on a genuine investment in an offshore PE fund. However, it does not elaborate on what would consistitute a genuine investment, let alone what would contitute an arm's length return on such an investment. It does note that an arm's length return should be reasonably comparable to a return made on the same type of investment made by an external investor, however this also creates uncertainty as to what might consistute a 'reasonably comparable reutrn'.

The comments are not limited to Hong Kong investment advisors and also raise the possiblity of taxing fund executives, who participate in carried interest arrangements if the nature of the return they receive differs from a normal investment return recevied by external investors.

These comments are likley to create considerable uncertainty within the PE industry as it is far from clear whether amounts received pursuant to commonly adopted carried interest structures should be taxable in Hong Kong either through attribution to a Hong Kong investment adivser or in the hands of a fund executive.

Tax Residency Certificates

DIPN 51 also contains some brief comments on the ability of SPVs established by an offshore PE fund to obtain a tax residency certificate from the IRD, which is often a prerequisite for claiming benefits under a double tax treaty. These comments underscore the increasing scrutiny faced by Hong Kong incorporated companies from the IRD when applying for tax residency certificates.

The comments in DIPN 51 suggest that a tax residency certificate could be issued to a Hong Kong incorporated SPV, where it has 'substantial business activities' in Hong Kong (e.g., where the SPV has permanent offices or employs staff in Hong Kong to hold and administer its investments in private companies). However, it is difficult to reconcile these comments with the restrictions referred to earlier on the types of activities that an SPV can perform in order to satisfy the requirements of the new SPV definition.

In practice, we anticipate that it is going to be difficult for a genuine SPV to obtain a tax residency certificate even if the majority of the PE fund's investment professionals are based in Hong Kong. Given that obtaining a residency certificate is a requirement for claiming treaty benefits in China, this could have a material impact on investment returns for China focussed PE funds, which have historically sought to hold investments through Hong Kong SPVs.

Conclusion

When first announcing the intention to expand the offshore funds exemption, the Financial Secretary of Hong Kong noted that this, along with other measures introduced at the same time, was intended to strengthen Hong Kong's position as a premier international asset management centre. KPMG China welcomed this initiative at the time and has continued to be supportive of the concept.

The issuance of the new DIPN represented an opportunity for the IRD to address the key areas of uncertainty created through the drafting of the July 2015 Legislation. While it has touched on many of the key issues, some of the comments will create uncertainty within the industry over how the rules will operate. Questions that remain include how the rules will apply to the IPO exit of an investment by a PE fund, the nature of the activities that can be performed by an SPV in order to fall within the SPV exemption and how the safe harbour thresholds should be measured for determining a Qaulifying Private Company. In addition, the comments on carried interest will create a significant degree of uncertainty going forward.

Many of these matters should have been discussed through a consultation phase prior to the issuance of the guidelines to ensure that they adequately addressed the concerns of the industry.

KPMG China will work with relevant industry bodies in the forthcoming months to highlight the shortcomings in the IRD guidance to government officials and push for additional clarity to be provided to enable the PE industry to benefit from the extended exemption in the manner in which the government originally intended.

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