The long-awaited DIPN on tax exemption for offshore private equity funds still leaves some issues to be addressed

2 June 2016

Financial Services Tax News Flash

In brief

The Inland Revenue Department (**IRD**) issued Departmental Interpretation and Practice Notes No. 51 (**DIPN 51**) on 31 May 2016 setting out its views on various issues relating to the application of the offshore private equity fund tax exemption regime. DIPN 43 was also revised at the same time to reflect the IRD's latest interpretation and practice relating to the offshore fund tax exemption regime as a whole. While there is now clarity on some issues, some challenges and unanswered questions remain.

Overview

The offshore fund profits tax exemption regime has been extended with effect from 1 April 2015 whereby offshore private equity funds and their special purpose vehicles (**SPVs**) will be exempt from Hong Kong profits tax if the relevant requirements are met.

DIPN 51 and revised DIPN 43 set out the IRD's views on a number of issues that are the subject of debate under the extended as well as the original tax exemption regime.

Challenges / unanswered questions

The IRD's stance	PwC's comment
1. Interest income	
The IRD wishes to end the long debate on the treatment of interest income under the original offshore fund tax exemption regime. Paragraph 24 of DIPN 43 explicitly states that "*the holding of debentures, loan stocks, bonds or notes to earn "interest income" is not a transaction in securities since such holding does not involve two transacting parties and cannot be regarded as a transaction. The interest derived therefrom could only be considered as derived from incidental transactions and not specified transactions.*" The consequence is that interest income, if Hong Kong sourced, would be subject to the 5% threshold for incidental transactions, which if exceeded, would render the fund being subject to tax on the relevant income from all incidental transactions.	This interpretation of the IRD, which may be subject to challenge, will affect investment funds that invest in debt securities, in particular fixed income funds and private equity funds investing in convertible bonds or similar instruments. Such investment funds should review their situation and seek further advice on how this issue should be addressed.
2. Qualifying funds	
DIPN 51, paragraph 40 indicates that for the purposes of determining whether a private equity fund is a "qualifying fund", it would not be inappropriate to see through the feeder funds when counting the number of investors of the private equity fund as "*feeder funds are often vehicles to account for the needs of the investors and may not have independent existence of their own.*" The IRD will examine the totality of facts including the constitutive documents to determine whether it is appropriate to see through the feeder vehicle.	It remains to be seen how this would be implemented in practice, in particular under what circumstances the feeder funds would be considered as not having "independent existence of their own".

The IRD's stance	PwC's comment
3. SPV activities	
An SPV, as defined in the legislation, 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 excepted private companies (**EPCs**). In this regard, DIPN 51, paragraph 47, states that the SPV: • should not engage in an active business with buying and selling transaction (i.e. trading transactions); • cannot derive service fees from the offshore fund; • is expected to only derive passive dividend income from one or more EPCs; • is to hold and administer EPCs in the capacity as a shareholder or holder of participation or equity interest; • cannot engage in the management of the business of the EPCs; and • can only perform the following activities: reviewing 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 company secretary and auditor. In terms of the tax residence of an SPV, paragraph 81 states that in deciding whether a tax residence certificate can be issued to an SPV, factors such as whether the SPV has a permanent office or employs staff in Hong Kong will be examined to determine whether it has substantial business activities in Hong Kong. In particular, the IRD will refuse to issue a tax residence certificate if the SPV is a mere conduit.	The very limited scope of activities that an SPV can perform may pose challenges for private equity funds trying to enjoy tax treaty benefits since there are increasing requirements on the level of "substance" maintained by an SPV as required by tax authorities around the world, in particular the PRC.
4. IPO	
DIPN 51, paragraph 53, states that if an offshore private equity fund "*sells its investment in an EPC through an initial public offering ("IPO"), it is in substance no different from a transaction in listed securities or a transaction in securities of an EPC*". As such, the private equity fund will continue to be eligible for profits tax exemption of the divestment if the other specified conditions are satisfied.	Although not explicitly stated, it should imply that the disposal of listed securities by an SPV through IPO should be in substance no different from a transaction in securities of an EPC and thus eligible for profits tax exemption (since an SPV is allowed to invest in an EPC). However, as mentioned in item 3 above, the SPV should note that it should not engage in the buying and selling of the listed shares after the IPO.
5. Tainting	
The IRD has made it very clear (DIPN 51, paragraph 54 refers) that where an offshore private equity fund carries on any business in Hong Kong other than the specified transactions and incidental transactions, such other business will taint the fund and the fund will lose its tax exemption status for all its income.	Private equity funds as well as hedge funds with private investments need to review their situation and assess how this potential issue should be managed and monitored.

The IRD's stance	PwC's comment
6. Bona fide widely held	
For the purposes of determining whether an offshore private equity fund will be regarded as "bona fide widely held" such that the deeming provision will not apply, the IRD indicates 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*".	This implies that the usual benchmark figures of "no fewer than 50 investors" and "no fewer than 21 persons holding 75% or more of the fund" will equally apply to private equity funds. If an offshore private equity fund fails to meet these benchmark figures, it will be regarded as bona fide widely held only if the IRD is satisfied that the fund was established with a view to wide public participation and genuine efforts are being taken with the aim of achieving that objective. This probably is an assessment to be made on a case-by-case basis by taking into consideration the relevant facts and circumstances of the fund and the relevant documents.
7. Carried interest	
DIPN 51 includes a section on taxation of investment manager. In that section, the IRD states for the first time in a DIPN its views on the taxation of carried interest / performance fees received by fund investment managers. The key messages are: • Investment managers and advisors should be adequately remunerated for their services 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 fund; • For a private equity fund that is a limited partnership, distributions (unless comparable to the return arising on investments made by external investors in the fund) received by the general partner may be attributed under the general anti-avoidance provisions (**GAAR**) to the investment manager or advisor as profits derived from services rendered in Hong Kong; • The place where Hong Kong investment managers or advisors rendered their services will further be examined before deciding the extent to which the management fees or carried interest attributable to the Hong Kong investment managers or advisors should be charged to profits tax. That is, whether the arm's length management fees or carried interest should be wholly assessable; and • Distributions (unless comparable to the return arising on investments made by external investors in the fund) from a general partner limited partnership or a carried interest limited partnership to fund executives of the investment manager or advisor may be chargeable to salaries tax as employment income or profits tax as services income through applying the GAAR if the distributions are not genuine investment returns.	Whether or not carried interest should be taxable in Hong Kong is controversial and has been subject to debate. In the absence of consensus on the matter, using GAAR to seek to tax carried interest may be subject to challenge since investment managers may argue that carried interest arrangements in the market is a commercial practice.

Takeaway

While DIPN 51 and revised DIPN 43 provide clarity on a number of issues, some issues remain to be addressed.

In order to manage the Hong Kong profits tax position and increase the likelihood of being eligible for the benefits under the Hong Kong tax treaties, investment funds need to carefully plan their holding and operational structures.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your usual PwC contact or one of the following:

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