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Proposal to Extend Hong Kong's Offshore Fund Exemption to Private Equity: A Step in the Right Direction

The Financial Services Development Council (FSDC), an advisory body to the Hong Kong SAR government on the promotion and development of Hong Kong's financial services industry, released six research papers in November 2013[1]. Among these papers, Research Paper No. 6 (Paper) proposed certain tax exemption and anti-avoidance measures that would apply to private equity (PE) funds. A tax exemption for PE funds (Proposed Rule) was first proposed by Hong Kong's Financial Secretary in the 2013/14 budget speech. Subsequently, in the 2014/15 budget speech on February 26, 2014, the Financial Secretary confirmed that the legislative process regarding the Proposed Rule would commence in the near future, with the expectation that the Proposed Rule would be introduced in mid-2014.

Exempting offshore PE funds from Hong Kong profits tax is a step in the right direction to make Hong Kong more competitive in attracting nonresident PE funds to set up in Hong Kong. The Paper proposed a number of conditions related to the qualification of a PE fund for a tax exemption under the Proposed Rule, including the following:

- The PE fund could not be a real estate fund or real estate investment trust (REIT); and
- The PE fund could invest, directly or indirectly, in non-Hong Kong-incorporated "portfolio companies" that (i) do not carry on any business in Hong Kong or (ii) hold Hong Kong real estate (unless it meets the 10% de minimis exemption threshold)[2].

The Paper also sets out the FSDC's recommendations on the Hong Kong tax treatment of Special Purpose Vehicles (SPVs) typically used by PE funds in making portfolio investments, and on how the existing anti-avoidance measures can be relaxed to provide more flexibility for PE funds.

We welcome the FSDC suggestions, but hope that the Financial Services and the Treasury Bureau will provide more guidance and clarification on the following when the new legislation is introduced.

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[1] The research papers focus on different topics, including (i) strengthening Hong Kong as a leading global international financial center; (ii) proposals to advance the development of Hong Kong as an offshore Renminbi center; (iii) development and reform of Mainland China's financial sector and the strengthening and enhancement of Hong Kong's pivotal role as a financial center; (iv) developing Hong Kong as a capital formation center for real estate investment trusts; (v) proposals on legal and regulatory framework for open-ended investment companies in Hong Kong; and (vi) a synopsis paper proposing tax exemptions and anti-avoidance measures on private equity funds in the 2013-14 budget. Details of these research papers can be found at FSDC's website at www.fsdc.org.hk.

[2] A portfolio company would meet the 10% de minimis threshold if its Hong Kong immovable property holdings do not exceed 10% of its net asset value at any time during the year of assessment and the two immediate preceding years of assessment.

Real estate funds

The Paper proposes that the current safe harbor rule[3] be extended to cover PE funds, except for real estate funds and REITs. The definition of a REIT is clearly stated in the Hong Kong REIT Code, and the proposed Hong Kong tax treatment for REITs was discussed in FSDC Research Paper No. 4. However, it does not appear that Paper No. 6 provides an actual definition of "real estate funds," nor does the Paper, or other synopsis papers issued by the FSDC, discuss how real estate funds should be taxed in Hong Kong.

We believe it is important to clearly define the term "real estate fund." Logically, a real estate fund should be a fund with substantial investments in real estate, but that is not considered a REIT under the Hong Kong REIT Code. However, it is unclear whether a fund would be considered a real estate fund if all or most of its real estate investments are outside Hong Kong. The classification also is unclear if, for example, a fund has 50% of its value invested in real estate, while the other 50% is invested in manufacturing concerns. Should the definition of a real estate fund take into account the geographic location of the real estate, or should it include a bright-line test for the percentage of the fund's real estate investments?

De minimis threshold

The Paper suggests that PE funds that invest in a portfolio company with "incidental investments" in Hong Kong real estate of less than 10% of its net asset value would be exempt from Hong Kong profits tax under the Proposed Rule. It is unclear why the threshold would be set at 10% and not higher, since the 10% level could discourage investment in certain portfolio companies with active businesses. For example, if a portfolio company operates an active manufacturing business in China, but also owns a Hong Kong warehouse, the value of which exceeds 10% of the total asset value of the portfolio company, a PE fund that invests in the portfolio company might not be able to benefit from the profits tax exemption under the Proposed Rule. Therefore, it appears that the 10% threshold suggested in the Paper could make the Proposed Rule less attractive for certain PE funds. If the de minimis rule must contain a specified percentage, applying this threshold to the PE fund as a whole (i.e. at the level of the fund, but not at the level of the portfolio company) would help avoid disqualification from the Proposed Rule if only one portfolio company exceeded the 10% threshold (as illustrated in our example above).

Additionally, further clarification is needed on how the de minimis exemption threshold should be determined, i.e. whether it should be based on fair market value, net book value, or historical cost and at which dates.

Portfolio companies

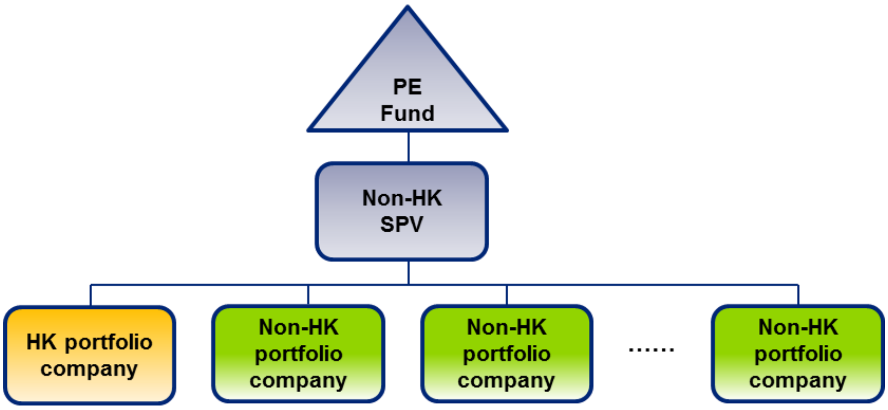
The Paper suggests that PE funds that invest, directly or indirectly, through Hong Kong and/or non-Hong Kong-incorporated (or established) SPVs into "portfolio companies" should be exempt from profits tax if certain conditions are satisfied (e.g. the 10% de minimis exemption threshold mentioned above that applies to portfolio companies). Portfolio companies are defined as private companies that are incorporated or registered outside Hong Kong and do not carry on business in Hong Kong.

We have the following observations with respect to portfolio companies:

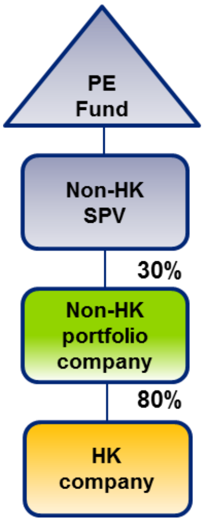
Restriction on incorporation in Hong Kong: Arrangements that potentially could lead to undesirable effects, due to the restriction on the incorporation of portfolio companies in Hong Kong under the Proposed Rule, are illustrated in the following diagrams and are described below.

[3] The current safe harbor rule (i.e. section 20AC of the Inland Revenue Ordinance) exempts the profits of offshore funds from specified transactions, such as buying and selling of Hong Kong listed securities through a specified person (e.g. licensed brokers) in Hong Kong.

Example 1:



Example 2



In Example 1, if a PE fund acquires a group of businesses predominately operating overseas, and the target group comprises a Hong Kong portfolio company (shown in orange), it appears that the PE fund may not be exempt from Hong Kong profits tax under the Proposed Rule. In other words, a single Hong Kong portfolio company would taint the whole group from obtaining the Hong Kong profits tax exemption.

Example 2 assumes that a PE fund acquires, through its non-Hong Kong-incorporated SPV, a 30% interest in a non-Hong Kong portfolio company that does not hold any Hong Kong real estate at the time of the acquisition. However, the non-Hong Kong portfolio company subsequently expands its business and acquires an 80% shareholding in a Hong Kong- incorporated company (shown in orange). It appears that the PE fund would no longer qualify for the profits tax exemption under the Proposed Rule after the acquisition of the Hong Kong company by the non-Hong Kong portfolio company, even though the PE fund’s 30% minority interest in the non-Hong Kong portfolio company likely means it has no control over the non-Hong Kong portfolio company and its decision to acquire the Hong Kong company.

We understand that the legislative intent of excluding Hong Kong private companies from the current safe harbor rule is to avoid exempting funds dealing in shares of Hong Kong companies that own underlying assets that are not intended to be exempt (e.g. Hong Kong real estate property). However, given that the Proposed Rule already excludes investment in "land-rich" portfolio companies (see discussion above regarding the 10% minimum threshold), there may not be a need to restrict the definition of portfolio companies to non-Hong Kong-incorporated companies. In fact, removing this restriction could encourage PE funds to invest in Hong Kong businesses, which could boost the Hong Kong economy while avoiding the potential undesirable effects described above.

Restriction on carrying on business in Hong Kong: As mentioned, there do not seem to be any material differences in the requirements for a Hong Kong company and an overseas company to become a portfolio company, given that being incorporated in Hong Kong does not automatically mean a company will carry on a business in Hong Kong. The reverse also is true.

Given the relatively low threshold of "carrying on business in Hong Kong" under the Inland Revenue Ordinance (IRO), a non-Hong Kong-incorporated portfolio company easily may be considered as carrying on a business in Hong Kong, even if it has only limited activities in Hong Kong (e.g. in the Bartica case)[4]. For example, if a non-Hong Kong-incorporated portfolio company owns real estate in Hong Kong for leasing purposes (assuming the value of the real estate is within the 10% de minimis or other designated exemption threshold), the non-Hong Kong portfolio company will be deemed to be carrying on a business in Hong Kong according to the definition of "business" under section 2 of the IRO. This would result in a PE fund that invests in that non-Hong Kong portfolio company losing the tax exemption under the Proposed Rule, notwithstanding that the value of real estate falls within the de minimis exemption threshold.

Therefore, we believe it is necessary to clearly define the circumstances under which a portfolio company will not be considered to be carrying on a business in Hong Kong under the Proposed Rule. One possibility that could make the Proposed Rule more user-friendly would be to allow a tax exemption for PE funds investing into portfolio companies (regardless of the place of incorporation), provided the activities of the portfolio companies do not constitute a permanent establishment (PE)[5] in Hong Kong. The threshold for a PE generally is higher than that of carrying on a business in Hong Kong. Even though this approach might not resolve the above situation where a non-Hong Kong portfolio company owns a property in Hong Kong for leasing purposes (as the portfolio company may, depending on the circumstances, be regarded as carrying on a business through a PE in Hong Kong), it may at least exclude certain situations where a non-Hong Kong portfolio company has limited activities in Hong Kong (e.g. maintaining a bank account in Hong Kong, as in the Bartica case) from being considered as carrying on a business in Hong Kong. It would be even more welcomed by the PE industry if the entire restriction on carrying on business in Hong Kong were removed.

Hong Kong-incorporated SPVs

According to the Paper, if a tax-exempt PE fund invests, directly or indirectly, through a wholly-owned (or majority owned or controlled[6]) Hong Kong-incorporated SPV that derives only passive income (e.g. dividend income) and profits from the disposal of portfolio companies, the SPV also should be exempt from Hong Kong profits tax under the Proposed Rule. This provision likely would make Hong Kong SPVs more appealing vehicles for PE funds to use to invest in portfolio companies. However, some practical issues, as illustrated in the following example, may need to be considered for purposes of this provision.

Example 3:

In Year 1, a PE Fund acquires a PRC portfolio company through two wholly-owned Hong Kong-incorporated SPVs, HK SPV 1 and HK SPV 2. After the acquisition, the group restructures. As part of the restructuring, certain business activities are introduced into HK SPV 2 for purposes of enabling it to be considered the beneficial owner of the PRC portfolio company under Mainland China's Circular 601[7]. Consequently, HK SPV 2 derives not only dividend income from its PRC investment, but also active operating income from Year 2 onwards, while HK SPV 1 derives only dividend income. In Year 5, the PE fund exits its investment by having HK SPV 1 dispose of HK SPV 2 and its underlying PRC portfolio company to a third party through a trade sale, and the disposal profits are booked by HK SPV 1.

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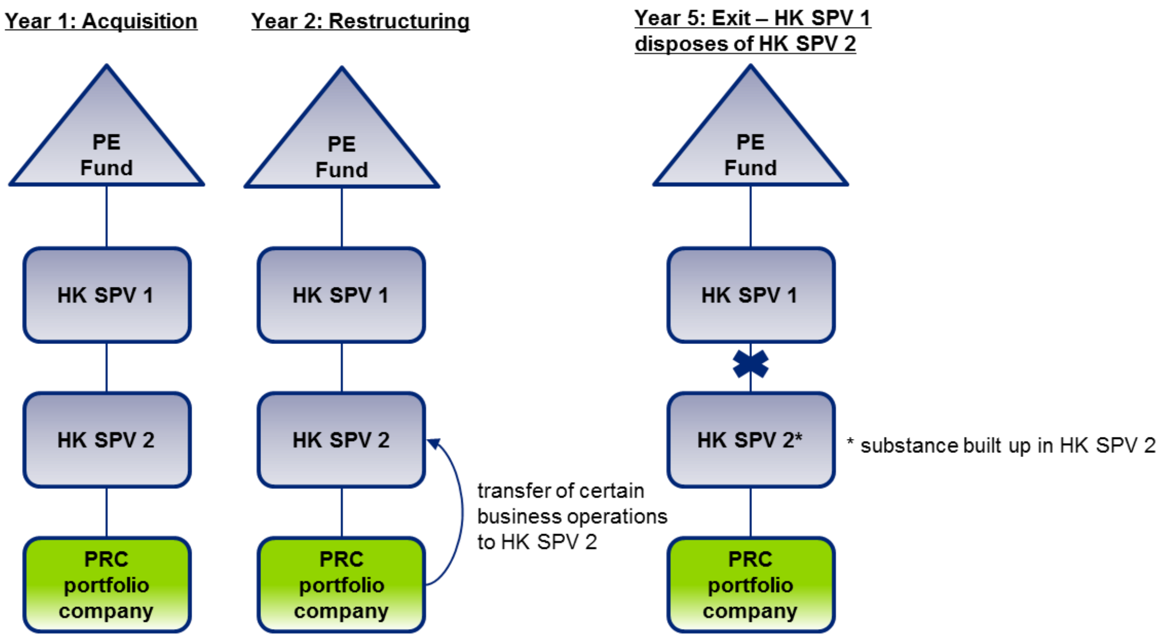
[4] In *CIR v. Bartica Investment Ltd, 4 HKTC 129*, the rolling over of certain bank deposits in Hong Kong for higher interest income was held to constitute a business in Hong Kong.

[5] "Permanent establishment is defined under Inland Revenue Rule No. 5 as "a branch, management or other place of business, but does not include an agency unless the agent has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of his principal or has a stock of merchandise from which he regularly fills orders on his behalf."

[6] The meaning of "majority owned or controlled" in this context is somewhat unclear. Does it include a situation where a fund has only a 50% or lower shareholding in an SPV, but it exercises certain control in the SPV through participation in the SPV's board of directors?

[7] HK SPVs often are used by investors for the purpose of investing into Chinese portfolio companies, due to the reduced dividend withholding tax rate of 5% under the China-Hong Kong double tax arrangement. However, to enjoy this preferential treatment, the Chinese tax authorities require the Hong Kong SPV to qualify as the "beneficial owner" of the Chinese portfolio company, i.e. to have substantial operating activities in Hong Kong, according to Circular 601.



There are three potential issues to consider in this example:

1. **Whether HK SPV 2 would be regarded as a "portfolio company" under the Proposed Rule: Under the Proposed Rule:** HK SPV 2 should be eligible for the profits tax exemption in Year 1 because it did not derive any active income for that year (assuming the PE Fund satisfies all the necessary tax exemption conditions). Starting from Year 2, however, HK SPV 2 had some active business operations and derived active operating income in Hong Kong, in addition to receiving passive dividend income. It is unclear whether HK SPV 2 would be regarded as a portfolio company, as opposed to a SPV, from Year 2 onwards. If it is regarded as a portfolio company, it is unclear whether the PE fund, HK SPV 1 and HK SPV 2 would lose their profits tax exemptions under the Proposed Rule starting from Year 2 and be subject to Hong Kong profits tax on their Hong Kong-source profits (except capital gains). A possible way to resolve this issue would be to consider our suggestion above of allowing a portfolio company to be a Hong Kong-incorporated company, which may or may not carry on a business in Hong Kong, as long as it is not "land rich."

2. **Whether the loss of tax-exempt status by HK SPV 1 and/or HK SPV 2 "taint" the PE fund's entire profits tax exemption under the Proposed Rule:** Assuming HK SPV 2 is regarded as a "portfolio company" from Year 2, this could result in the PE Fund losing its profits tax exemption from Year 2 onwards. The next question is whether the PE Fund would lose the profits tax exemption only for particular investments made through HK SPV 2, or whether it would lose the exemption for all of its other investments as well. We suggest a clear bright-line test be introduced, so that there will be no "tainting" unless the value of nonexempt investments exceeds a certain threshold percentage of the value of the entire PE fund.

3. **How "business" of Hong Kong-incorporated SPVs should be defined:** According to the Paper, a SPV is defined as a company that derives only passive income (e.g. dividend income) and profits from disposals of portfolio companies. It appears that the "allowed" business activities of Hong Kong SPVs are very limited. With Hong Kong's rapidly expanding tax treaty network and the increasing emphasis at an international level on "real business substance" of contracting parties in a treaty context, it would be to Hong Kong's advantage if Hong Kong SPVs were allowed to perform certain additional activities in Hong Kong. This largely would facilitate the operations of PE funds in Hong Kong and benefit the overall Hong Kong economy.

Definition of "investor" in a master/feeder fund structure

Under the current safe harbor rule, anti-avoidance measures (i.e. the deeming provisions under section 20AE of the IRO) will not apply when an offshore fund is regarded as "bona fide widely held." The Proposed Rule would relax the bona fide widely held rule (from a minimum of 50 investors to a minimum of five investors), which is a step in the right direction because PE funds may not have as large of a number of investors as hedge funds. However, clarity should be provided for certain master/feeder structures where investors invest indirectly into a master fund that makes direct investments through separate feeder funds. We believe that investors in feeder funds should be counted when considering the number of investors in the master fund, so that the bona fide widely held condition would be applicable for both the master fund and feeder funds in a master/feeder structure.

Other suggestions

The Paper does not propose any tax incentives for fund management companies in Hong Kong. In contrast, other countries such as Singapore provide lower tax rates (10%) for fund management companies in a bid to lure more fund managers to their jurisdictions. This may be worth considering by the Hong Kong SAR government, if its aim is for Hong Kong to become a regional fund management center. At a minimum, clear guidance should be given by the Hong Kong Inland Revenue Department on how to determine the nature and source of a fund management entity's income and the value of its activities (e.g. fundraising and marketing, investment management and back office administration) attributable to its income with reference to generally accepted transfer pricing principles.

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