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Tax
Issue H63/2015

Tax Analysis

Hong Kong Tax

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Update on proposed Hong Kong profits tax exemption for private equity funds

The proposal to extend Hong Kong's profits tax exemption for offshore funds to private equity (**PE**) funds was first mentioned in the 2013/14 budget. In November 2013, the Financial Services Development Council (**FSDC**), an advisory body to the Hong Kong Special Administrative Region government, released a synopsis paper (**FSDC proposal**) setting out its recommendations on the proposed law[1]. The government has since held two rounds of industry-wide consultations. On 5 January 2015, a legislative proposal on the new law was presented to the Legislative Council Panel on Financial Affairs. An Inland Revenue (Amendment) Bill 2015 (**Bill**) in connection with the proposed law was introduced to the Legislative Council on 20 March 2015. The law will become effective when published in the Gazette and should apply retrospectively to transactions carried out from 1 April 2015.

Summary of the Bill

The Bill does not provide for a wholesale tax exemption for all transactions conducted by PE funds in Hong Kong. Instead, it is aimed at attracting certain overseas PE funds to Hong Kong and, thus, it would exempt only certain PE transactions (generally those that do not have many Hong Kong ties or connections). It is hoped that these funds would be able to set up their management business (i.e. the fund managers) in Hong Kong, which would further strengthen Hong Kong's position as the premier management center in Asia. As expected, the government wishes to retain its taxing rights over income with a Hong Kong "situs," so the proposed measures are limited in scope. Consequently, PE funds that are targeted for the exemption generally are those that would invest in businesses that are carried on outside Hong Kong.

Below is a summary of the conditions that would have to be satisfied for the proposed tax exemption to apply:

- The PE fund would have to be a nonresident.
- The PE could conduct only "specified transactions," including transactions in securities in an eligible private company (i.e. a portfolio company[2] or a special purpose vehicle (**SPV**)).

[1] See Deloitte's Tax Analysis (Issue H58/2014) issued on 13 June 2014. References to our previous commentary generally refer to this article.
[2] The term "excepted private company" is used under the Bill to mean "portfolio company." For the purposes of this article, the term "portfolio company" will be used in place of "excepted private company."

- A "portfolio company" would mean a private company[3] incorporated outside Hong Kong which, at all times during a three-year "look-back" period:
  - Did not carry on any business through or from a permanent establishment in Hong Kong; and
  - Subject to a "de minimis rule,"[4] did not (i) hold share capital of any company carrying on any business through or from a permanent establishment in Hong Kong; (ii) hold immovable property in Hong Kong; or (iii) hold share capital of companies that hold immovable property in Hong Kong.
- An SPV could be a corporation, partnership, trustee of a trust estate or any other entity, registered or appointed in or outside Hong Kong, and wholly or partially owned by a nonresident. However, the SPV would have to be established solely for the purpose of holding (directly or indirectly) and administering one or more portfolio companies, and could not carry on any other business in Hong Kong.

- A nonresident PE fund that is not managed by a person licensed under the Securities and Futures Ordinance could enjoy the profits tax exemption if it meets the following criteria of a "qualifying fund"; that is, at all times after the fund's final closing:
  - There are more than four investors in the fund (excluding the originators and their associates);
  - Capital commitments by investors exceed 90% of the fund's aggregate capital commitments; and
  - The originators of the fund and their associates do not receive more than 30% of the net proceeds of the fund, after deduction of capital contributions.
- A profits tax exemption would be provided to an SPV in respect of its profits derived from transactions in certain securities of an interposed SPV or a portfolio company (e.g. gains from the disposal of a portfolio company or from the disposal of an SPV that owns a portfolio company).
- An anti-avoidance provision has been added to tax Hong Kong resident persons' shares of profits in the PE fund that are attributable to an SPV's tax-exempt profits.[5]

Although it is encouraging to see that many of the suggestions mentioned in the commentary in our previous article are reflected in the Bill, there remain a number of unresolved issues that are discussed below. Some of the key positions in the Bill, which include changes to the FSDC proposal, are as follows:

1. ***No exclusion for real estate funds/Real Estate Investment Trusts (REITs)***

   In the FSDC proposal, the tax exemption was proposed to exclude real estate funds and REITs. The commentary in our previous article questioned whether there would be a need to exclude real estate funds/REITs from the scope of the tax exemption, given that there already would be an exclusion for Hong Kong "land rich" portfolio companies (subject to the 10% de minimis rule, discussed below). Consistent with our suggestion, the Bill would not exclude real estate funds/REITs from the scope of the tax exemption.

2. ***Relaxation of restriction on carrying on business in Hong Kong***

   Under the FSDC proposal, a company would not qualify as a portfolio company if it carries on any trade or business in Hong Kong. The commentary in our previous article pointed out that this might render the conditions for eligibility for the tax exemption too restrictive, given the relatively low threshold for what would constitute "carrying on a trade or business in Hong Kong" under Hong Kong's domestic law. Our commentary suggested an alternative to make the new rule more user-friendly, i.e. to allow an offshore fund to invest in a portfolio company, provided the activities of the portfolio company do not rise to the level that would

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[3] A "private company" is a company that is not allowed to issue an invitation to the public to subscribe to shares or debentures of the company.

[4] See item 3, under “Tightening of de minimis rule,” below.

[5] Although a similar anti-avoidance rule exists in the current offshore fund regime (the **existing rule**), this particular rule with respect to an SPV's exempt profits is rather unusual. Currently, the existing rule applies where a fund directly derives profits from the disposal of an investment, and its Hong Kong resident investors (meeting certain conditions) are then required to pay tax on those profits on an accrual basis, i.e. without the actual receipt of distributions from the fund. This is somewhat similar to the US tax concept under which partners are taxable on their allocable share of income from a partnership in which they are a partner, regardless of whether they have actually received distributions from the partnership. However, the new rule would apply, not with respect to profits derived directly by the fund, but to profits derived indirectly by the fund through the SPV. In other words, the Hong Kong resident investors in the fund would be required to pay tax on a "deemed" basis with respect to the fund's ownership in the SPV, which is somewhat similar to the current inclusion rules in the controlled foreign corporation regime in the US. This type of current inclusion rule could be considered a novelty, or at least a rarity, in Hong Kong's tax regime.

constitute a permanent establishment in Hong Kong. In other words, if a portfolio company conducts only auxiliary or preparatory activities in Hong Kong, the offshore fund still should be able to enjoy the tax exemption for transactions in that portfolio company. The Bill would relax the restriction on carrying on business in Hong Kong by adopting this suggestion.

3. *Tightening of de minimis rule*

In the FSDC proposal, the only restriction with respect to classification as a "portfolio company" (other than the requirement related to carrying on business in Hong Kong, discussed above) would have been an asset test, i.e. a portfolio company could not have any direct and/or indirect holding in immovable property in Hong Kong exceeding 10% of its net asset value for a three-year look-back period.

The Bill would increase the restrictions for classification as a portfolio company as follows:

i. At all times during the three years before a transaction in securities in the portfolio company takes place, the aggregate value of the portfolio company's direct or indirect equity interests in one or more private companies carrying on any business through, or from a permanent establishment in, Hong Kong could not exceed 10% of the value of the portfolio company's own assets (**business test**); and

ii. At all times during the three years before a transaction in securities in the portfolio company takes place, the aggregate value of the portfolio company's direct holdings in immovable property in Hong Kong, and its direct or indirect equity interests in one or more private companies with direct or indirect holdings of immovable property in Hong Kong, could not exceed 10% of the value of the portfolio company's own assets (**asset test**).

Thus, in addition to the asset test under the FSDC proposal, the Bill would introduce a business test with the same three-year look-back period. The addition of the business test would further limit the scope of the investments of a portfolio company and the business activities of its underlying investments, i.e. the private companies (which can be Hong Kong or non-Hong Kong companies) in which it has a direct or indirect equity interest.

Even if a portfolio company and its direct or indirect equity investments satisfy both tests on “day one,” they may fail either or both tests in the future due to factors outside the control of the PE fund, or even the portfolio company itself. For example, assume that a PE fund acquires a minority stake in a portfolio company predominantly operating overseas, which subsequently acquires a Hong Kong company with an insignificant Hong Kong business (relative to the group's overall business) but that owns an office building in Hong Kong that has a value exceeding 10% of the asset value of the portfolio company. In such a case, although the subsequent acquisition by the group cannot be "controlled" by the PE fund, given that it holds only a minority stake in the portfolio company, it appears that the PE fund no longer would be eligible for the tax exemption under the asset test (or the business test). Therefore, as highlighted in the commentary in our previous article, it would be desirable to impose both tests only in cases where the PE fund has "real control" over both the portfolio company and the private companies in which the portfolio company has a direct or indirect equity interest.

The three-year look-back period under the Bill would mean that if either test is not met at any point in time during the three-year period prior to the transaction, the exemption would not be available. This requirement seems rather stringent, as it would require constant monitoring of the asset and business tests over the holding period of the relevant investment. It is questionable whether the PE fund would have sufficient information available to make such a determination, especially where its investment in the portfolio company is a minority stake.

The Bill is unclear as to what the terms "value" and "own assets" mean for the purposes of the business test and the asset test. Does value mean book value (net or gross), or market value? If it is book value, how should intangible assets that have a significant value but that are not reflected in the company’s books be treated? Does the term own assets include intangible assets that are not recorded in the books? Again, the necessary value determinations likely would prove difficult, especially for a PE fund that does not control the relevant investments.

4. *Relaxation of restrictions on activities of Hong Kong SPVs*

The proposed exemption would cover transactions in securities in a Hong Kong SPV, which may be viewed as a step in the right direction, as it would promote the use of Hong Kong companies for investment holding purposes. Compared with the conditions set out in the FSDC proposal, the Bill appears to have relaxed the restrictions on a Hong Kong SPV's activities by allowing such an entity to conduct "administrating activities" for portfolio companies. This change, although slight, seems to be in response to an issue raised in the commentary in our previous article: that a PE fund could lose its tax exemption if the Hong Kong SPV performs certain activities in Hong Kong for purposes of substantiating its business substance to qualify for treaty benefits. However, we believe that further guidance is needed as to what level of administrative activities is allowable, and whether any service fees received by the Hong Kong SPV for providing such administrative activities would cause the entity to be disqualified as an SPV and lose its profits tax exemption.

Additional suggestions

Although the government, in drafting the Bill, largely responded positively to the recommendations provided in our previous article, as well as other feedback received during the industry-wide consultations, we hope that the following suggestions may also be considered in developing the new law:

Tainting

Under the current offshore fund exemption provisions, if an offshore fund conducts any transaction other than "specified" or "incidental" transactions, the entire exemption would be "tainted" for the fund, i.e. a tax exemption no longer would be available for the fund.

As mentioned above, we understand that the Bill proposes to apply a 10% threshold on the "aggregate value" of the direct and/or indirect holdings in Hong Kong businesses (business test) or Hong Kong immovable property (asset test) by a portfolio company, with a three-year look-back period. If this threshold is not exceeded at the time the PE fund transacts in the securities of the portfolio company, the exemption still would be available. If, however, the threshold is exceeded with respect to one portfolio company, all the other transactions (which otherwise would be eligible for the exemption) would be tainted, i.e. the fund no longer would be eligible for the exemption on any other such transaction. Given the lack of control by the fund in certain circumstances, as explained above, this tainting issue easily could arise. That being the case, perhaps the fund should lose its tax exemption only in respect of the “nonspecified” transactions, rather than being tainted entirely?

Would this tainting problem readily be overcome by interposing an SPV between the PE fund and a portfolio company, such that the disposal by the SPV of a disqualifying portfolio company would not be considered a transaction of the fund and, hence, not a nonspecified transaction of the fund?

Bona-fide widely held funds

The Bill confirms that anti-avoidance measures (i.e. the deeming provision in Section 20AE) under the existing Offshore Fund Exemption Law equally would apply to offshore PE funds, to prevent abuse or “round-tripping” by local PE funds disguised as offshore funds. However, the deeming provision would not apply if the tax-exempt fund is "bona-fide widely held."

The current threshold for a bona-fide widely held fund, as set out in the Departmental Interpretation and Practice Notes No. 20 (i.e. having a minimum of 50 investors and, at no time, fewer than 21 investors holding 75% or more of the interests in the fund), could be very difficult to meet, given that the number of investors in a PE fund usually is significantly smaller than the number in, for example, a hedge fund. In this regard, we believe the bona-fide widely held condition should be relaxed for PE funds (e.g. to more than four investors, as in line with the definition of a "qualifying fund" under the Bill), and clear guidelines should be issued by the Inland Revenue Department (**IRD**) on how the number of investors should be determined (for example, in a master-feeder structure and a parallel fund structure).

Hong Kong portfolio companies

The Bill currently provides that transactions in portfolio companies would have to satisfy the following conditions (among others): (i) the companies are incorporated outside Hong Kong; and (ii) they do not carry on any business through or from a permanent establishment in Hong Kong. In view of the fact that the current offshore fund exemption provides a tax exemption for offshore hedge funds trading in "specified securities," which could include Hong Kong listed shares of Hong Kong-incorporated companies, it would appear worthwhile for the government to consider whether the proposed tax exemption for offshore PE funds also should cover transactions in portfolio companies that are incorporated in Hong Kong or that carry on a business through a permanent establishment in Hong Kong, provided the business test and the asset test are met.

In addition, the exclusion of Hong Kong-incorporated companies as portfolio companies under condition (i) above may have the unintended effect of preventing PE funds from investing in Hong Kong-incorporated companies that have all of their businesses outside Hong Kong and generate only offshore profits. These Hong Kong-incorporated companies generally only maintain a very low level of business activities, if any, in Hong Kong and should, in most cases, meet the condition (ii) of "not carrying on any business through or from a permanent establishment in Hong Kong" as if they had been nonresident companies. If this requirement can be relaxed, i.e. by adopting only condition (ii) but not condition (i), it would help expand the scope of allowable investments by PE funds, thereby making the exemption regime more attractive.

Investments into Hong Kong start-ups and creative industries

In the 2015/16 financial budget, the government proposed various measures to promote Hong Kong start-ups and local creative industries, including fashion design, film development and the arts. If the scope of an "allowed investment" under the new offshore fund provisions could be extended to these start-ups and creative businesses as a special incentive, it might attract more PE fund investments into these promoted Hong Kong sectors. However, this would require an expansion of the definition of a portfolio company under the Bill to specifically cover Hong Kong start-ups and creative businesses.

Reduced tax rate for Hong Kong fund managers

The Legislative Council Brief of 17 March 2015 states that "the Bill will help attract more offshore private equity fund managers to set up or expand their business in Hong Kong." The tax exemption for offshore funds should, therefore, have as one of its objectives to encourage more offshore funds to set up their investment management businesses in Hong Kong. However, the Bill would provide tax benefits for PE funds, but no specific tax benefits for fund managers. Given that the 2015/16 financial budget proposes to attract multinational and Mainland China enterprises to establish corporate treasury centers in Hong Kong to perform treasury services for their group companies, perhaps a similar tax reduction regime should be considered for asset management businesses in Hong Kong.

However, such a regime could raise additional questions. If fund managers relocate to Hong Kong because of the tax exemption afforded to the offshore funds they manage, does this mean that more of their management fees and carried interests would then be allocated to Hong Kong and be subject to Hong Kong tax? Would this be a concern that might give fund managers pause in moving to Hong Kong?

Conclusion

As the Bill has been introduced into the Legislative Council, PE funds should continue to monitor the development of the proposed new law, especially in areas that require further clarification by the IRD. In the meantime, PE funds should review their operational structures and assess their eligibility for the tax exemption under the proposed new law, and plan their next moves accordingly.

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