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Hong Kong Profits Tax Exemption for Private Equity Funds: Now a Reality

The long-anticipated Hong Kong profits tax exemption for offshore private equity ("PE") funds was finally enacted on July 17, 2015 ("the law"), and applies retroactively to transactions carried out as from April 1, 2015 (see the article, "Hong Kong Profits Tax Exemption for Private Equity Funds,"[1] for our previous commentary on the legislation). This article provides an update to our previous article, with new comments and observations.

I. Summary of the Law

The law 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 exempts only certain PE transactions (generally those that do not have many Hong Kong ties or connections). It is hoped that these funds will 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 a key management center in Asia. As expected, the government wishes to retain its taxing rights over income with a Hong Kong "situs," so the 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 must be satisfied for the tax exemption to apply, along with other relevant provisions of the law:

- The PE fund must be a nonresident.
- The PE fund may conduct only "specified transactions", including transactions in the securities of an eligible private company (i.e. a portfolio company[2] or a special purpose vehicle ("SPV")).
    - A "portfolio company" means 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

[1] "Hong Kong Profits Tax Exemption for Private Equity Funds", Tax Planning International Review, Vol. 42, No. 5 (May 2015).
[2] The term "excepted private company" is used under the law to mean "portfolio company." For the purposes of this article, the term "portfolio company" will be used in place of "excepted private company."
[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.

- subject to a "10% de minimis rule,"[4] did not (i) hold share capital of a company carrying on 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 may 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 must be established solely for the purpose of holding (directly or indirectly) and administering one or more portfolio companies, but may not carry on any other business in Hong Kong.

- A nonresident PE fund whose transactions are not carried out through or arranged by a person licensed under the Securities and Futures Ordinance may 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 the deduction of capital contributions.

- A profits tax exemption is 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 from our previous article are reflected in the law, a number of unresolved issues remain, which are discussed below.

II. Some Key Positions in the Law

Some of the key positions in the law, which include changes to the Financial Services Development Council ("FSDC") proposal that set forth recommendations on the proposed law, are as follows:

A. No Exclusion for Real Estate Funds/Real Estate Investment Trusts ("REIT"s)

In the FSDC proposal, the tax exemption was proposed to exclude real estate funds and REITs. We previously questioned whether there was 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 law does not exclude real estate funds/REITs from the scope of the tax exemption.

B. Relaxation of restriction on carrying on business in Hong Kong

Under the FSDC proposal, a company would not have qualified as a portfolio company if it carried on any trade or business in Hong Kong. We previously 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. We 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 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

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[4] See under "Tightening of de minimis rule," below.

[5] Although a similar anti-avoidance rule exists in the offshore fund regime, this particular rule with respect to an SPV's exempt profits is unusual. The rule applies where a fund directly derives profits from the disposal of an investment, and its Hong Kong resident investors (meeting certain ownership threshold requirements) are 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 U.S. 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 actually have received distributions from the partnership (in contrast, Hong Kong generally treats the partnership as a separate person subject to tax). However, the new rule applies to profits derived directly by the fund, as well as to profits derived indirectly by the fund through the SPV. In other words, the Hong Kong resident investors in the fund are required to pay tax on a "deemed" basis with respect to the fund's ownership in the SPV. This type of current inclusion rule may be considered a novelty, or at least a rarity, in Hong Kong's tax regime.

able to enjoy the tax exemption for transactions in that portfolio company. The law relaxes the restriction on carrying on business in Hong Kong by adopting this suggestion.

C. 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 law increases 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 may 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, may 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 law introduces a business test with the same three-year look-back period. The addition of the business test further limits the scope of the investments of a portfolio company and the business activities of its underlying investments, i.e. the private companies (which may 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 we highlighted before, 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 in the future.

The three-year look-back period under the law means that if either test is not met at any point in time during the three-year period prior to the transaction, [6] the exemption will not be available. This requirement seems rather stringent, as it requires constant monitoring of the asset and business tests over the holding period of the relevant investment. It is questionable whether the PE fund will have sufficient information available to make such a determination, especially where its investment in the portfolio company is a minority stake.

The law 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? [7] 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 will prove difficult, especially for a PE fund that does not control the relevant investments.

D. Relaxation of Restrictions on Activities of Hong Kong SPVs

The exemption covers 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 law 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 our previous commentary: 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

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[6] In a public seminar held in August 2015, the Inland Revenue Department ("IRD") appeared to have formed an initial view that the term "transaction" refers to a disposal, as opposed to an acquisition of an investment. . The IRD also has clarified that only the book values of the relevant assets on the balance sheet of the previous accounting year-end date will be relevant for this purpose.
[7] However, see footnote 6 regarding the IRD's clarification on "value."

Kong SPV for providing such administrative activities would cause the entity to be disqualified as an SPV and lose its profits tax exemption.

Further guidance also may be appropriate since the OECD issued a final report on base erosion and profit shifting ("BEPS")[8] action 6, "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances" on October 5, 2015, which contains a recommendation for a "limitation-on-benefits" ("LOB") rule that generally[9] would require resident companies to pass an "active conduct of business test" to become a "qualified person" for the purpose of enjoying treaty benefits under the OECD model tax convention. The test would require resident companies to conduct an active business, and specifically would exclude "headquarters operations," i.e. making or managing investments for the resident companies' own accounts. In light of the restriction on an SPV's scope of business under the law, most SPVs likely would not be able to enjoy tax treaty benefits under the BEPS LOB rule. The Hong Kong government may want to consider how to alleviate concerns in this regard.

III. Additional Suggestions

Although the government, in drafting the law, largely responded positively to the recommendations provided in our previous article, as well as other feedback received during industry-wide consultations, we hope that the following issues also may be clarified in the new/revised departmental interpretation and practice note to be issued, or in future legislation.

A. Tainting

Under the 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 would no longer be available for the fund.

As mentioned above, the law applies 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 will 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 would no longer 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?

B. Bona-fide Widely Held Funds

The law confirms that anti-avoidance measures (i.e. the deeming provision in Section 20AE) under the existing Offshore Fund Exemption Law equally apply to offshore PE funds, to prevent abuse or "round-tripping" by local PE funds disguised as offshore funds. However, the deeming provision will 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 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 law), and clear guidelines should be issued by the IRD on how the number of investors should be determined (for example, in a master-feeder structure and a parallel fund structure).

C. Hong Kong Portfolio Companies

The law provides that transactions in portfolio companies must 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

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[8] In a G-20 meeting in November 2012, the leaders called for coordinated actions to strengthen international tax standards and to support the OECD in identifying possible gaps in tax laws. As a consequence, the OECD published a report known as "Addressing Base Erosion and Profit Shifting" in February 2013, aimed at combating abusive cross-border tax arrangements. Subsequent work has continued on various actions relating to BEPS.

[9] Listed companies, banks, insurance companies, securities dealers and any other institution agreed upon by the contracting states to a treaty would not be required to pass the active conduct of business test to become qualified persons.

permanent establishment in Hong Kong. In view of the fact that the 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 tax exemption for offshore PE funds should be modified going forward to 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 maintain only a very low level of business activities, if any, in Hong Kong and should, in most cases, meet 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 could be relaxed in the future, i.e. by retaining 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.

D. Investments into Hong Kong Start-ups and Creative Industries

In the 2015/16 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" could be extended to these start-ups and creative businesses as a special incentive in the future, 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 law to specifically cover Hong Kong start-ups and creative businesses.

E. Reduced Tax Rate for Hong Kong Fund Managers

The Legislative Council Brief of March 17, 2015 states that the law "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 law provides tax benefits for PE funds, but no specific tax benefits for fund managers. Given that the 2015/16 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?

IV. Conclusion

Since there are still a number of uncertainties under the law, PE funds should continue to monitor the development of additional guidance relating to the 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 law, and plan their next moves accordingly.

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