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HK FINANCIAL SERVICES DEVELOPMENT COUNCIL 香港金融發展局

Synopsis Paper Proposing Tax Exemptions and Anti-avoidance Measures on Private Equity Funds in the 2013-14 Budget

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Background

1. In 2006, the HKSAR Government introduced profits tax exemptions for offshore funds if their activities in Hong Kong are restricted to specified transactions and transactions incidental thereto. However, specified transactions do not include transactions in private companies, which are commonly seen in private equity ("**PE**") funds. This has resulted in PE funds taking onerous procedures to mitigate their potential exposure to Hong Kong profits tax. This has put Hong Kong in a relatively disadvantaged position for attracting PE funds to Hong Kong.

2. The Financial Secretary announced in his 2013-14 Budget Speech that profits tax exemptions for offshore funds will be extended to include transactions in private companies which are incorporated or registered outside Hong Kong and do not hold any Hong Kong properties or carry out any business in Hong Kong. This initiative will allow offshore PE funds to enjoy the same tax benefits as other offshore funds and attract more PE funds to Hong Kong.

3. The Financial Services Development Council ("**FSDC**") has been engaged in giving recommendations on how the existing profits tax exemptions for offshore funds can be refined, subject to putting appropriate anti-avoidance measures in place. The FSDC has taken a phased-in approach for its work. This paper summarises the key recommendations of the FSDC for the current phase of its work.

Tax comments

4. The Safe Harbour Rule[1] should be extended to cover PE funds[2] (see Appendix for an illustration), which are managed or advised by Hong Kong Securities and Futures Commission ("**SFC**") licensees[3] ("**fund manager**") whose power ranges from full discretionary powers to make investment decisions on behalf of the PE funds to providing investment recommendations to investment committees or general partners who have full discretionary investment powers (the "**extended Safe Harbour Rule**"). PE fund investments are generally structured in three ways:

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1 Section 20AC of the Inland Revenue Ordinance (Revenue (Profits Tax Exemption for Offshore Funds) Ordinance 2006) (as proposed to be expanded in the 2013-14 Budget Speech).

2 Excludes real estate funds or real estate investment trusts ("REITs").

3 See paragraph 7.2, which contemplates qualification for the extended Safe Harbour Rule otherwise than by being an SFC licensee.

4.1 First, PE funds that directly invest into portfolio companies[4] and / or invest into portfolio companies via one or more non-Hong Kong incorporated (or established) special purpose vehicles ("**SPVs**"):

4.1.1 PE funds that invest directly into portfolio companies, and such portfolio companies do not hold any Hong Kong real estate (i.e. the portfolio companies are not Hong Kong "land-rich" companies), such PE funds should be exempt from Hong Kong profits tax under the extended Safe Harbour Rule.

4.1.2 PE funds that invest into a portfolio company, and directly or indirectly hold Hong Kong real estate, such PE funds should be exempt from Hong Kong profits tax under the extended Safe Harbour Rule if such a portfolio company (which holds Hong Kong real estate) meets the "10% de minimis exemption threshold"[5]. That is, provided that a portfolio company has incidental investments in Hong Kong real estate of less than 10% of its net asset value, the extended Safe Harbour Rule should continue to apply to the entire PE fund.

4.1.2.1 To follow the spirit of the current Safe Harbour Rule, the exemption under the extended Safe Harbour Rule should continue to be automatic (i.e. no application required).

4.1.2.2 The "10% de minimis exemption threshold" should be a "self-satisfying" requirement. As an anti-avoidance measure, a disclosure / declaration that the "10% de minimis exemption threshold" has been met shall be made at the standalone portfolio company level.

4.1.2.3 If a portfolio company exceeds the "10% de minimis exemption threshold" due to market fluctuations (e.g. 11% of a portfolio company's assets are Hong Kong real estate), the Safe Harbour Rule may continue to apply to the PE fund (and its remaining portfolio companies), provided that the PE fund is a bona fide PE fund that does not invest into Hong Kong real estate (other than the incidental investment(s)).

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4 Being private companies, which are incorporated or registered outside Hong Kong <u>and</u> do not carry out any business in Hong Kong.

5 For example, the portfolio company would exceed the 10% de minimis threshold if its Hong Kong immovable property holding exceeded 10% at any time during the year of assessment and two immediately preceding years of assessment. "Three year holding period" is suggested with reference to Article 6 of the China / Hong Kong tax treaty (*The Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*) in respect of its definition of "land-rich" companies.

4.1.2.4 "Quarantine steps" should be taken by such portfolio companies to ascertain the reasons why the "10% de minimis exemption threshold" was exceeded, e.g. due to market fluctuations. A declaration should be made by the fund manager of the PE fund, and has to be confirmed with / agreed to by the Inland Revenue Department ("**IRD**").

4.2 Secondly, PE funds that invest into portfolio companies via one or more Hong Kong incorporated SPVs[6]:

4.2.1 If the SPV is 100% (i.e. wholly / solely) held by a single PE fund, and the PE fund is exempt from Hong Kong profits tax under the extended Safe Harbour Rule, the SPV should be exempt from Hong Kong profits tax under the extended Safe Harbour Rule. In order for the exemption to apply, the SPV should need to disclose in its Hong Kong profits tax return:

- The name of the PE fund;
- The name of the PE fund's fund manager; and
- The "Central Entity Number" of the PE fund's fund manager issued by the SFC to licensed persons and registered institutions[7].

4.2.2 If the SPV[8] is held jointly by a PE Fund and co-investors, and the SPV is majority owned or controlled by the PE fund, and the PE fund is exempt from Hong Kong profits tax under the extended Safe Harbour Rule, the SPV should be exempt from Hong Kong profits tax under the Safe Harbour Rule, provided that the remaining co-investors of the SPV are not Hong Kong residents. The PE fund manager should be obliged to notify the IRD within 30 days of its becoming aware of any disqualifying event (i.e. in the event that a Hong Kong resident invests in the SPV).

4.3 A combination of the above.

[6] Hong Kong incorporated private limited liability companies governed by the Companies Ordinance of Hong Kong (irrespective of whether or not the SPV has Hong Kong directors). The SPVs should only derive passive income (e.g. dividend income) from the portfolio companies, and profits from disposal of the portfolio companies by trade sale or IPO in Hong Kong or outside Hong Kong.

[7] See paragraph 7.2, which contemplates qualification for the extended Safe Harbour Rule otherwise than by being an SFC licensee.

[8] We could borrow the idea although not the exact wordings of the definition of "special purpose vehicle" in the recent Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance, which essentially defines an SPV as any entity established solely for the purpose of the relevant alternative bond scheme and which does not carry on any trade or activities except for purposes of the relevant alternative bond scheme. For PE funds, the SPV would be exempt where all the other co-investors either qualify as exempt PE funds or are otherwise not Hong Kong residents.

5. **Deeming provisions**

5.1 The deeming provisions should not be invoked in cases where the PE fund is regarded by the IRD as "bona fide widely held", which should mean that at no time did fewer than 5 persons[9] hold (or have the right to become the holders of) all of the partnership interests of the PE fund.

5.2 Where the above benchmark figure is not met, the IRD by concession, should accept that the "bona fide widely held" requirement has been satisfied if it is clear from the constitutive documents of the PE fund (and other relevant materials), that the PE fund was established with a view to widening participation and that genuine efforts are / have been taken with the aim of achieving that "bona fide widely held" objective.

5.3 A grace period of 18 months after the PE fund's first closing should be granted to mitigate any unintended adverse Hong Kong profits tax implications to investors into the PE fund.

6. **General comments and other matters**

6.1 The "prescriptive" list in the current Safe Harbour Rule, e.g. for "specified transactions" should be replaced by an "exclusions list" (similar to the Singapore safe harbour rule).

6.2 Overseas regimes (including Singapore) should be studied for workable measures and justifications in setting numerical thresholds (e.g. "10% de minimis exemption threshold").

6.3 "Specified transactions" should include loans and credit transactions.

7. **Regulatory comments**

7.1 Fund managers need to be "specified persons" (i.e. licensed by or registered with the SFC under the Securities and Futures Ordinance ("**SFO**")) in order that the funds under their management may rely on the Safe Harbour Rule. We understand that this is a key anti-avoidance provision and, subject to paragraph 7.2 below, accordingly propose that a PE fund manager or adviser would need to be licensed with the SFC in order that the PE fund that it manages or advises may avail itself of the extended Safe Harbour Rule.

[9] This is less onerous in comparison to the current Section 20AE of the Inland Revenue Ordinance (of 50) given the majority of PE funds are in the form of limited partnerships, and as such, the minimum threshold should be adjusted accordingly.

7.2 However, the above requirement that fund managers / advisers need to be licensed with the SFC creates a significant obstacle specific to the PE industry. Many PE fund managers / advisers operating in Hong Kong are not required to be licensed by or registered with the SFC, and in many cases will not be granted a licence even if they were to apply for one. In view of this obstacle, PE funds managed by managers / advised by advisers which do not carry on business in a regulated activity in Hong Kong or which are otherwise exempt from the requirement to be SFC-licensed should be entitled to the extended Safe Harbour Rule, provided that such PE funds constitute eligible[10] "collective investment schemes" as defined in the SFO. The Financial Services and the Treasury Bureau, SFC and IRD would need time to work out the framework applicable to this category of PE fund managers / advisors.

7.3 To obtain the benefit of the extended Safe Harbour Rule (except as provided in paragraph 7.2), we would propose that it make no difference what type of licence (i.e. whether Type 1, 4, 9, etc) a fund manager holds with the SFC, provided it holds a licence. Again, this would be consistent with the current regime, even though "specified transactions" under the tax exemptions may include transactions that are in investments or instruments that are not regulated under the SFO (i.e. they are not necessarily in securities or futures contracts).

7.4 It is important that those PE fund managers that are not carrying on a business in a regulated activity in Hong Kong or that can avail themselves of a licensing exemption under the SFO are not forced into a position where they must become licensed by the SFC. We would propose that PE funds managed / advised by such PE fund managers / advisers be entitled to the statutory benefits of the extended Safe Harbour Rule by way of meeting the eligibility criteria referenced in paragraph 7.2 above, and that the extended Safe Harbour Rule would not in any way otherwise impact or compromise the position of PE firms that do not meet those criteria and that are currently unlicensed and intend to remain so. Firms which are not required by the SFC to hold a licence and which do not meet the eligibility criteria referenced in paragraph 7.1 and are not qualified as collective investment schemes as described in paragraph 7.2 should be allowed to continue business as usual, while of course foregoing the statutory benefits of the extended Safe Harbour Rule.

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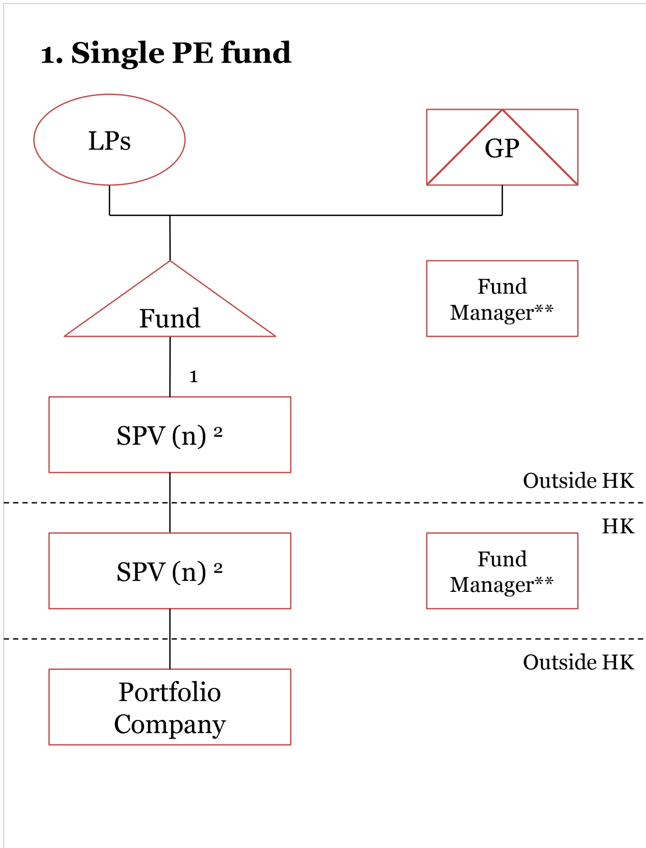
[10] See paragraph 8.1.

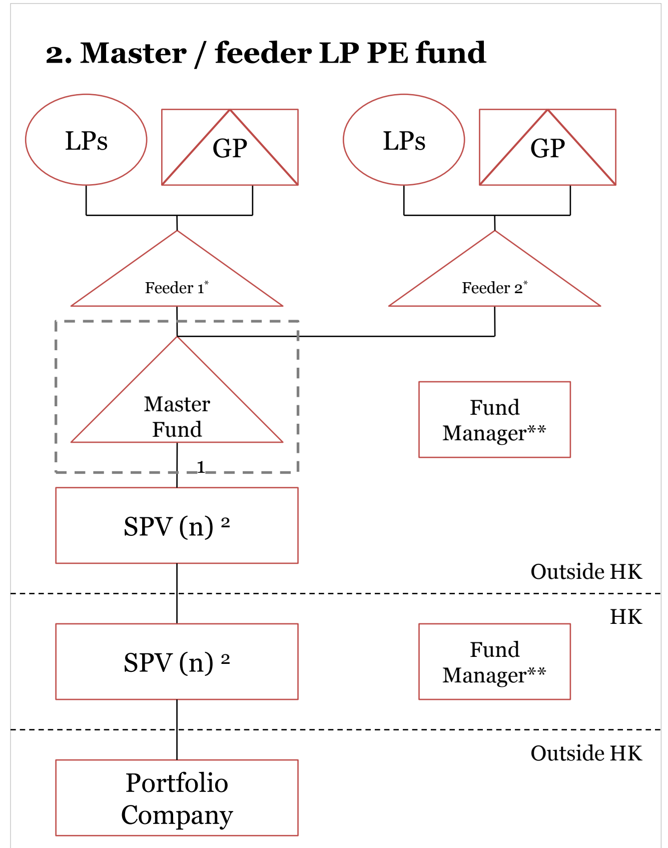
8. Phased approach for the project

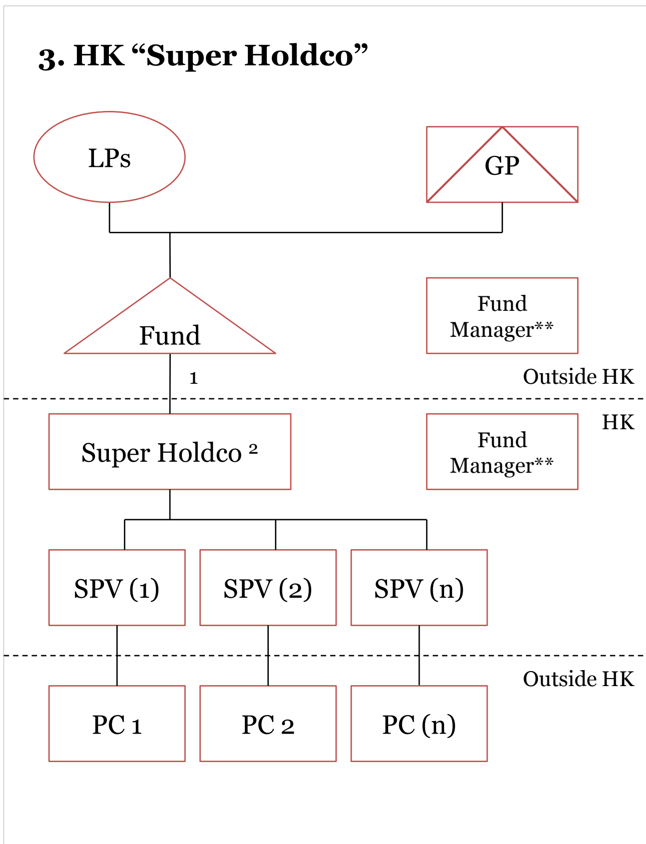
8.1 This synopsis paper represents Phase 1 of the project. For Phase 2, the FSDC will consider the following and make appropriate recommendations:

- Hong Kong domiciled limited partnerships;
- Hong Kong portfolio companies;
- Tax exemption eligibility criteria for PE funds which are “collective investment schemes” but not managed or advised by an SFC-licensee as discussed in paragraph 7.2 above;
- “Central management and control” test for an offshore fund;
- All investments in private companies (regardless of where the company concerned is incorporated and what business activities it undertakes); and
- Legal definitions (e.g. those on “securities” and “portfolio company”) and changes to the law.

Appendix – Typical PE fund structures (not exhaustive)







Key:

1 Sub-fund(s) may be interposed
2 SPV may be HK incorporated or non-HK incorporated
* There may be multiple feeder funds
** Fund Manager may be located in HK or outside HK
PC Portfolio company

About the Financial Services Development Council

The Hong Kong SAR Government announced in January 2013 the establishment of the Financial Services Development Council (FSDC) as a high-level and cross-sector platform to engage the industry and formulate proposals to promote the further development of Hong Kong's financial services industry and map out the strategic direction for development. The FSDC advises the Government on areas related to diversifying the financial services industry, enhancing Hong Kong's position and functions as an international financial centre of our country and in the region, and further consolidating our competitiveness through leveraging the Mainland to become more global.

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