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Tax Alert

HK Extends Tax Exemption to Cover Offshore Private Equity Funds

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On 17 July 2015, the Hong Kong Legislative Council enacted a new law to extend the existing provision of profits tax exemption for offshore funds to non-resident Private Equity ("PE") funds. The new exemptions will apply to relevant transactions occurring on or after 1 April 2015.

This alert briefly summarizes the background information, details of the amendment and our comments.

Background

The amendments are aimed to provide a boost to Hong Kong's PE fund industry. The total capital under management in PE funds in Hong Kong kept increasing for the past several years. However, Hong Kong is facing fierce competition from other international financial centres in attracting foreign investments.

In order to attract more offshore funds to Hong Kong so as to strengthen its position as Asia's leading asset management centre, the Hong Kong Government released draft legislation on 20 March 2015 to extend the profits tax exemption for offshore funds to PE funds. The long anticipating legislation was finally enacted on 17 July 2015.

Offshore Funds Tax Exemption (2006)

The Offshore Funds Tax Exemptions (2006) provides for exemption from Hong Kong profits tax for non-resident funds provided that:

- the funds' profit arose from "specified transaction" or transaction that is incidental to the carrying out of specified transaction;
- the transaction is carried out through, or arranged by, a "specified person"; and
- the fund is a qualifying non-resident fund.



Under the Offshore Funds Tax Exemption (2006), transactions in private companies' securities do not fall under the definition of "specified transactions" as defined in Schedule 16 of Inland Revenue Ordinance, thus gains derived by non-resident PE funds from investing in private companies could not enjoy the profits tax exemption.

Moreover, the Offshore Funds Tax Exemption (2006) requires the transactions to be carried out through or arranged by a person licensed with Securities and Futures Commission ("SFC"). In practice, offshore PE funds are not necessarily managed by SFC licensed persons.

Inland Revenue (Amendment) (No. 2) Ordinance 2015

Key features of the new amendment are:

- Widening the scope of exemption to transactions in the securities of non-Hong Kong eligible private companies (Excepted Private Companies "EPCs");
- Extending the exemption to include Special Purpose Vehicles ("SPVs"), which are established in Hong Kong to hold one or more EPCs.
- Waiving the requirement for transactions carried out by a person with a SFC license, provided that the offshore PE fund is a "qualifying fund"

An "EPC" is a non-Hong Kong private company at any time in the 3 years before the relevant transaction:

- is incorporated outside Hong Kong;
- did not carry on business through or from a permanent establishment in Hong Kong;
- did not hold (whether directly or indirectly) one or more private companies carrying on any business through or from a permanent establishment in Hong Kong, or the aggregated value of such holding is no more than 10% of the value of its own assets;
- did neither hold any immovable property in Hong Kong, nor hold (whether directly or indirectly) one or more private companies with holding of immovable property in Hong Kong, or the aggregated value of such holding is no more than 10% of the value of its own assets.

The new law also contains the following requirements in order for a PE fund to be regarded as a "qualifying fund":

- the fund must have more than 4 investors not including the originator and its associates;
- the capital commitments made by the investors exceed 90% of the aggregate capital commitments;
- the portion of the net proceeds arising out of the transactions of the fund to be received by the originator and the originator's associates is not exceeding 30% of the net proceeds;



Furthermore, the gain from disposal of an EPC or interposed SPV by a Hong Kong or non-Hong Kong incorporated SPV would also be exempt from profits tax, giving that the SPVs are partly or wholly owned by a non-resident PE fund and formed solely for the purpose of holding (whether directly or indirectly) or administrating one or more EPCs and does not carry on any other trade or activities.

Comments

The Amendments will make it considerably easier for the PE funds to operate in Hong Kong and should encourage more offshore PE fund managers to set up or expand their business in Hong Kong and thus will generate demand for local asset management, investment, advisory and other professional services.

Whilst we welcome the good news of such extended exemption, there are still uncertainties in the application of the amended legislation, it is hoped that the Inland Revenue Department would issue practice note so as to provide further clarifications.

Furthermore, it may be necessary for the PE funds or SPVs to implement certain changes, with commercial substance, in their operation, as a result of the enactment of the new rules. In such case, tax exposures in associate with their operational changes, as well as transfer pricing implications need to be carefully considered. For more information, please contact our tax team.

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