Hong Kong Expands Existing Offshore Funds Tax Exemption to Benefit Private Equity Funds

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Introduction

On 17 July, 2015 Hong Kong enacted legislation[1] to expand the existing offshore funds tax exemption to benefit non-resident private equity funds. The expanded exemption (the "2015 Amendment") applies to the payment of tax chargeable on the assessable profits of a Hong Kong incorporated or resident investment holding entity (i.e. a special purpose vehicle owned by an offshore[2] fund) resulting from transactions in offshore portfolio companies which are private companies. The change applies to transactions occurring on or after 1 April, 2015. The policy intent behind this is to encourage private equity firms to use Hong Kong as a platform for locating their investment holding entities with which to hold offshore investments (e.g. in Mainland China), and in doing so to take advantage of Hong Kong's growing network of double taxation treaties[3]. The scope of the expanded exemption does not change the basis of taxation of profits deriving from any other activities that are carried out onshore, including those of fund managers located in Hong Kong.

This is a significant and welcome development. However, the interpretation of the expanded exemption is unclear in places and it is hoped that these points will be clarified once the Hong Kong Inland Revenue ("IRD") issues its anticipated practice note on the expanded exemption.

Background: Hong Kong's Tax System and the Tax Exemption pre- the 2015 Amendment

A quick overview of the nature of Hong Kong's tax system and an explanation of the limitations on the scope of the original exemption is first needed to understand the motivation behind these changes and their intended impact.

Hong Kong's Territorial Tax System

Hong Kong has a territorial system of taxation and will only impose a charge to profits tax on a person carrying on a business in Hong Kong in respect of profits arising in or derived from Hong Kong from that business i.e. profits

1. The Inland Revenue (Amendment) (No. 2) Ordinance.
2. "Offshore" in this article refers to "offshore from Hong Kong". Likewise, "onshore" refers to "onshore in Hong Kong"
3. As at the time of writing, Hong Kong has comprehensive double taxation agreements with 31 other jurisdictions, and is also negotiating or has concluded negotiations for double taxation agreements with 14 additional jurisdictions. It also has a comprehensive double taxation arrangement with Mainland China.

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which are Hong Kong sourced. Notably, Hong Kong does not have a capital gains tax so that gains arising from the sale of capital assets (rather than trading assets) are excluded from the charge to profits tax. However, a capital receipt may be re-characterized as a trading receipt if the applicable tests[4] are satisfied, and if so, then the profits derived from that receipt will be assessable to Hong Kong profits tax. Prior the introduction of the original offshore funds exemption in 2006, a person, whether resident or non-resident, was chargeable to profits tax on trading profits derived from securities transactions carried out in Hong Kong if those transactions amounted to the carrying on of a trade or business. Conversely, profits tax was not (and still is not) chargeable on offshore profits or capital gains, including those arising from securities transactions[5].

The 2006 Exemption

The 2006 exemption (“2006 Exemption”) was enacted in response to lobbying from the fund management industry in Hong Kong after the IRD had started to issue profits tax returns to offshore funds. If an offshore fund derived trading profits from securities transactions carried out through an agent i.e. its broker in Hong Kong, the activities of the onshore agent could be attributed to the offshore fund. And if those activities amounted to the carrying on of a business in Hong Kong, profits of the fund from those trades could be subject to tax[6].

The key components of the 2006 Exemption were that a non-resident person (including corporations and partnerships) would not be subject to tax on profits derived from (i) “specified transactions” that were (ii) carried out in Hong Kong through or arranged by a “specified person”. Additionally, to qualify for the exemption, the non-resident person must not carry on any business in Hong Kong in addition to the specified transactions, except for a limited scope of transactions which were incidental to the carrying out of the specified transactions[7]. Any onshore non-qualifying transactions would cause the tainting of all specified transactions of the offshore fund that would otherwise have qualified for the exemption for that year of assessment[8]. The scope of the 2006 Exemption largely confined its use to the activities of offshore hedge funds and did not address transactions typically carried out by private equity funds when investing in or through Hong Kong. The principal issues were these:

(a) “Specified transactions” included transactions in “securities”, but specifically excluded the shares of private companies. This largely ruled out the availability of the exemption for the types of investments typically structured by private equity funds.

(b) “Specified person” means a licensed corporation under Hong Kong’s licensing regime, which is administered by the Securities and Futures Commission. Typically, the onshore advisors of many offshore private equity funds are not licensed as either their activities fall outside of the scope of the regime, or they are able to claim an available exemption, and private equity funds might not typically execute their transaction through a licensed person.

The Government’s original motivation for excluding securities of private companies was its concern that their inclusion would encourage the round tripping of funds by Hong Kong residents. This could be achieved for example by the setting up of entities disguised as offshore funds, in particular in relation to Hong Kong property, to take advantage of the exemption.

As it was, the 2006 Exemption included anti-avoidance provisions that would attribute offshore profits to an onshore resident person who triggered a 30% ownership test in the offshore person.

4. In making its determination as to whether a taxpayer has been engaged in a trade, the IRD will apply the so called “badges of trade”. These are six factors which are influential in making this determination.
5. See IRD Departmental Interpretation Practice Note No. 20 (Revised) (June 2012 edition).
6. Exemptions were available but at that time only for a mutual fund, unit trust, or similar investment scheme authorized as a collective investment scheme by the Securities and Futures Commission, or where the Commissioner of Inland Revenue was satisfied that the mutual fund, unit trust, or similar investment scheme was a “bona fide widely held investment scheme” that complied with the requirements of a supervisory authority within an acceptable regulatory regime.
7. The exemption for incidental transactions is capped at 5% of all total trading receipts from both specified transactions and incidental transactions. If the 5% cap is exceeded, the exemption will not apply to all of the trading receipts from incidental transactions.
8. See paragraphs (b) and (c) of the “Requirements for the EPC” below which include 10% thresholds below which tainting will not occur.

Relaxation of Existing Exemption Requirements

The 2015 Amendment was the result of further lobbying by the private equity industry in Hong Kong that succeeded in persuading the administration of the merits of expanding the scope of the 2006 Exemption. The resulting exemption reflects the Government's stated policy of seeking to attract more offshore private equity fund managers to set up or expand their businesses in Hong Kong.

Broadly, the 2015 Amendment expands the scope of the 2006 Exemption to include the assessable profits of an onshore special purpose vehicle ("SPV") owned[9] by a non-resident person (the fund), derived from the disposal of the shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, an offshore portfolio company which is a private company[10]. The activities of the SPV in Hong Kong must be limited to holding and administering one or more offshore portfolio companies which are private companies (so-called an "excepted private company" ("EPC")).

The 2006 Exemption (as expanded by the 2015 Amendment) applies not only to profits from "specified transactions", but also to profits from incidental transactions to the extent they do not exceed 5% of the total trading receipts from all such transactions in the year of assessment in question. An important point is that the IRD treats as "incidental transactions" the receipt of interest income or dividends paid on securities acquired through specified transactions. For a "transaction" to qualify for the exemption, there must be a purchase or sale of the security. For example, interest income paid by an EPC to the SPV over the life of a debt security issued by the EPC, would not be treated as a "specified transaction" that would qualify for the exemption.

Requirements for the fund

"Qualifying fund"

An added requirement introduced by the 2015 Amendment for the exemption to apply is that the offshore fund must be a "qualifying fund". This is an alternative to the existing requirement of the 2006 Exemption that the transaction be carried out through a "specified person" and is in recognition of the position that many PE funds may not require an SFC licensed corporation to carry out their transactions. These criteria for a "qualifying fund" are that:

(a) at all times after the final closing of sale of interests (i) there are at least 5 investors in the fund, and (ii) the capital commitments made by investors exceed 90% of the aggregate capital commitments; and

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(b) the portion of the net proceeds arising out of the transactions of the fund to be received by the originator (i.e. sponsor) and the originator's associates, after deducting the portion attributable to their capital contributions (which is proportionate to that attributable to the investors' capital contributions), is agreed under a fund's governing documents to be an amount not exceeding 30% of the net proceeds.

How some of these will be applied in practice is not clear. Will a minimum of five investors be taken to mean the feeder funds, or the investors in those feeder funds? It is hoped that the further guidance to be issued by the IRD will clarify this and other areas of uncertainty.

"Central management and control"

Whether a fund, structured as a corporation or partnership, qualifies as a non-resident person will be determined by whether the fund's central management and control was exercised outside of Hong Kong in the year of assessment in question. The phrase "central management and control" is not defined in legislation but is a well-established judicially developed principle that refers to the highest level of control of the business of a company. The determination of its location is a question of fact. The IRD recognizes that the place where the central management and control is exercised is not necessarily the place where the main operations of the business are to be found, though the two may often coincide. Consequently, the IRD takes the position that the fact of an onshore presence of a manager or advisor of the offshore fund with discretion to manage the assets of that fund is not a conclusive factor in determining the residence of the fund. If the central management and control of the

9. The SPV may be wholly or partly owned by the non-resident person and the exemption will apply to profits to the extent of that person's percentage interest in the SPV.
10. The exemption also applies to an SPV that has disposed of any of those interests in an interposed SPV that itself holds any such interests in the offshore portfolio company.

fund is not exercised in Hong Kong, the fund can qualify for the exemption notwithstanding that its asset portfolios are managed by a Hong Kong manager with full discretion to do so[11]. This has previously required private equity firms to follow strict operating procedures to ensure non-resident treatment for the fund. Private equity firms intending to take advantage of the 2015 Amendment may be able to relax some of these procedures as regards the SPV or any interposed SPC that would qualify for the tax exemption.

Requirements for the SPV

The SPV refers to the Hong Kong incorporated or resident investment holding entity owned by the fund. "Special purpose vehicle" includes the corporation or partnership holding the securities of the EPC, that:

(a) is wholly or partially owned by a non-resident person (i.e. the fund or another vehicle);

(b) is established solely for the purpose of holding, directly or indirectly, and administering one or more EPCs;

(c) is incorporated or registered in or outside Hong Kong;

(d) does not carry on any trade or activities except for the purpose of holding, directly or indirectly, and administering one or more EPCs; and

(e) is not itself an EPC.

Given this limitation on the scope of the SPV's activities, a potentially difficult issue to be addressed when structuring an onshore SPV to take advantage of one of Hong Kong's double tax treaties, will be question of "substance" required to ensure that the benefits of the treaty will be available. To take an example, China's tax authority has certainly laid considerable emphasis on the need for "substance" under its own double tax arrangement with Hong Kong, requiring that the Hong Kong resident have office space, employees and operations, to obtain these benefits. It is not clear how these apparently conflicting requirements might be resolved.

Requirements for the EPC

The EPC refers to the offshore portfolio company held by the SPV. "Excepted private company", means a private company incorporated outside Hong Kong that, at all times within a 3 year look back period before the transaction in the securities of the EPC giving rise to the assessable profits:

(a) did not carry on any business through or from a permanent establishment in Hong Kong;

(b) either:
- (i) did not hold (whether directly or indirectly) share capital (however described) in one or more private companies carrying on any business through or from a permanent establishment in Hong Kong; or
- (ii) held such share capital, but the aggregate value of the holding of the capital is equivalent to not more than 10% of the value of its own assets; and

(c) either:
- (i) it neither held immovable property in Hong Kong, nor held (whether directly or indirectly) share capital in a private company with a direct or indirect holding of immovable property in Hong Kong; or
- (ii) it held such immovable property or share capital (or both), but the aggregate value of the holding of the property and capital is equivalent to not more than 10% of the value of its own assets.

The definition of "private company" has been broadened from that used in the 2006 Exemption, to mean a company incorporated in or outside Hong Kong that is not allowed to issue any invitation to the public to subscribe for any shares or debentures of the company. An issue with this formulation raised with the administration during the consultation phase, was whether it might include the general law of a jurisdiction that prohibits the issue of an invitation by a company to the public to subscribe for its shares, with the possible outcome that even a listed company could be treated as a private company. An alternative approach would have been to limit the location of this restriction to the company's constitutional documents. It is anticipated that this point will also be clarified in the expected IRD guidance.

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11. See IRD Departmental Interpretation Practice Note No. 43 (Revised) (February 2010 edition).

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Whilst the ceiling on the EPC’s activities referred to in (a) above rules out activities in Hong Kong that could amount to the creation of a permanent establishment, the EPC could still conduct what has been referred to as “auxiliary or preparatory” activities without jeopardizing the availability of the tax exemption.

Anti-avoidance Deeming Provisions

A mentioned earlier, the 2006 Exemption contains deeming provisions designed to prevent Hong Kong residents from claiming the benefit of the tax exemption by round tripping their investments disguised as offshore funds.

Broadly, these provisions will deem a resident person holding a 30% or more interest in the non-resident person (i.e. the fund) as deriving onshore a relative proportion of the assessable profits in respect of trading profits earned by the offshore person from specified transactions and incidental transactions carried out in Hong Kong. And if the non-resident person is an associate of the resident person, then no thresholds applies. The 2015 Amendment extends the anti-avoidance provisions by attributing (where applicable) a portion of the profits of the SPV to the resident person on the same basis as described above. The reasoning here is that the profits will be generated at the SPV rather than at the fund level. The 2006 Exemption also contained a safe harbor from the deeming provisions (regardless of the extent of their application) if the IRD was satisfied that the offshore fund was “bona fide widely held”[12]. This looks at the number of investors in the fund, but how this will apply to master-feeder and parallel fund structures has yet to be clarified.

Expected IRD Guidance

Following the enactment of the 2006 Exemption, the IRD issued a non-binding Departmental Interpretation and Practice Note that contained guidance and examples as to how the exemption would be applied in practice. It is expected that the IRD will issue a revised version of this Note to include the 2015 Amendment, over the next few months.

Conclusion

The 2015 Amendment has generally been welcomed by the private equity industry in Hong Kong as a necessary step on the way to achieving Hong Kong’s aspiration to be a leading financial services center, and one that seeks to correct the prior imbalance between the tax treatment of hedge funds and private equity funds investing in or through Hong Kong. For the moment however, until the IRD has issued its revised guidance, managers of offshore private equity funds may prefer to adopt a “wait and see” approach before they start to make changes to their investment structures and operating procedures allowing them to seek to take advantage of the new exemption. In any event, any such changes are going to require careful planning as to how much management activity can be brought onshore. And this might include consideration as to whether a separate platform might need to be established to take advantage of the new exemption when combined with Hong Kong’s tax treaty network, in particular to avoid tainting issues that might be caused by non-qualifying transactions (i.e. transactions which are not “specified transactions”) carried out onshore.

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12. Current guidance issued by the IRD (See IRD Departmental Interpretation Practice Note No. 20 (Revised) (June 2012 edition)) states that it may be presumed that the requirement is satisfied if during the year of assessment in question at no time did fewer than 50 persons hold (or have the right to become the holders of) all of the units or shares in the scheme, and at no time during the year did fewer than 21 persons hold (or have the right to become the holders of) units or shares that entitled the holders, directly or indirectly, to 75% or more, of the income or property of the scheme. Where these benchmark figures are not met, it will still be accepted in practice that the requirement has been satisfied if it is clear from the constitutive documents of the scheme and other relevant material that it was established with a view to wide public participation and that genuine efforts are being taken with the aim of achieving that objective (i.e. there is nothing to suggest that the scheme is intended to be a closely held investment vehicle).

