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RSM Tax Advisory (Hong Kong) Limited

羅 申 美 稅 務 諮 詢 有 限 公 司

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NEW PRACTICE NOTE ON PROFITS TAX EXEMPTION FOR OFFSHORE PRIVATE EQUITY FUNDS

The Hong Kong Inland Revenue Department ("IRD") has recently issued Departmental Interpretation and Practice Notes No. 51 on Profits Tax Exemption for Offshore Private Equity Funds ("DIPN 51") which set out its views and interpretation on the extension of offshore funds exemption to offshore private equity funds ("PE funds"). This Tax Flash highlights the salient points of the DIPN 51.

I) OVERVIEW

To strengthen Hong Kong's status as a premier international asset management centre, the Hong Kong Government issued the Inland Revenue (Amendment) (No. 2) Ordinance 2015 (the "2015 Ordinance"), which was passed in July 2015, in order to extend the tax exemption under the Revenue (Profits Tax Exemption for Offshore Funds) Ordinance 2006 (the "2006 Ordinance") to offshore PE funds.

Pursuant to the 2006 Ordinance, offshore funds are exempt from Hong Kong profits tax for profits derived from "specified transactions" carried out through or arranged by a "specified person" and "transactions incidental to the carrying out of the specified transactions". Transaction in securities is included as one of the specified transactions.

The 2015 Ordinance has amended the definition of "securities" to include shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a private company which is an excepted private company ("EPC") or a special purpose vehicle ("SPV"). As such, the transactions in investing/divesting interests in EPC and SPV, which are commonly undertaken by PE funds, would also be qualified for the tax exemption if they can satisfy other relevant exemption conditions from 1 April 2015.

As offshore PE funds are not necessarily managed by persons licensed by the Securities and Futures Commissions (i.e. specified persons), under the 2015 Ordinance, if an offshore fund is a Qualifying Fund, it will also be eligible for the tax exemption. For more details of the 2015 Ordinance and Qualifying Fund, please refer to our Tax Flash May 2015.

II) DIPN 51

The IRD has set out its interpretation on the 2015 Ordinance and its view on taxation of investment manager in the DIPN 51. The following key issues have been addressed in the DIPN 51:

a) Tax Residence of PE funds;
b) Definitions of EPC and SPV;
c) Initial Public Offering ("IPO") Cases;
d) Requirements of Qualifying Funds;
e) Tainting Effect;
f) Deeming Provisions;
g) Arm's Length Fee of Investment Manager;
h) Tax Treatment on Performance Fee or Carried interest; and
i) Tax Residence of SPV.

a) Tax Residence of PE funds

Many PE funds are structured as limited partnerships. A PE fund is regarded as a non-resident person if the central management and control of the limited partnership is exercised outside Hong Kong. The fact that the general partner resides in Hong Kong does not necessarily lead to the conclusion that the central management and control of the PE fund is located in Hong Kong. The crucial issue is to determine the place where the management and control is exercised by the general partner.

b) Definitions of EPC and SPV

An EPC is defined as a private company incorporated outside Hong Kong; and at all times within the three years before the specified securities transaction giving rise to the relevant profit is carried out, the EPC:

a) did not carry on any business through or from a permanent establishment in Hong Kong;
b) did not hold (directly or indirectly) share capital in one or more private companies carrying on any business through or from a permanent establishment in Hong Kong; or the aggregate value of such holding did not exceed 10% of the value of its own assets; and
c) did not hold (directly or indirectly) any immovable property in Hong Kong or one or more private companies which (directly or indirectly) hold any immovable property in Hong Kong or the aggregate value of such holding does not exceed 10% of the value of its own assets.

When applying the 10% safe harbour rule, the market value of the holding of share capital and immovable property and the market value of the total assets of the EPC should be used in the calculation. However, debts of the EPC including liabilities secured by mortgages on the relevant immovable property cannot be deducted in calculating the value of the total assets of an EPC. Only gross amount of the asset values are used in the calculation.

An SPV is not allowed to carry on any trade or activities other than for the purposes of holding, directly or indirectly, and administering one or more EPCs.

The SPV should merely hold and administer the EPCs as a shareholder. The SPV would not be allowed to involve in the maintenance and administration of the business of EPCs. As indicated in DIPN 51, the activities of the SPV should be restricted to

- the review of financial statements of EPCs normally made available to shareholders or investors;
- attending the shareholders' meetings of EPCs;
- opening bank accounts for collection of dividends or investment receipts; and
- appointing company secretary and auditor.

The SPV is expected to only derive passive dividend income from one or more EPCs.

c) IPO Cases

If an offshore PE fund, which is qualified for the tax exemption under the 2015 Ordinance, sells its investment in the EPC through an IPO, the IRD considers it is in substance no different from a transaction in listed securities or a transaction in securities of an EPC. As such, the offshore PE fund will continue to be eligible for Hong Kong profits tax exemption. Conversely, if a listed company after privatisation is sold as an EPC, the offshore PE will continue to be exempt from profits tax in respect of the gain realised on the disposal.

d) Requirements of Qualifying Funds

A Qualifying Fund should have at least 5 investors (other than the originator and the originator's associates) whose capital commitments exceed 90% of the aggregate capital commitments and the originator and the originator's associates would not receive over 30% of the fund's net proceeds.

Some fund investors may use multi-layer ownership structure e.g. parallel funds or master-feeder funds structure for setting up their PE funds. The IRD considers feeder funds are often vehicles to account for the needs of the investors and they may not have independent existence on their own. The IRD may see through the fund structure when counting the number of investors.

e) Tainting Effect

If an offshore PE fund carries on any other business in Hong Kong other than the specified transactions and transactions incidental to the carrying out of specified transactions, the other business carried out by the fund will taint the fund and the fund will lose its tax exemption status.

f) Deeming Provisions

To prevent abuse of round-tripping by local PE funds and other entities disguised as offshore funds, the deeming provisions for offshore funds will also be applied for offshore PE funds. A Hong Kong resident person (alone or jointly with his associates) holding a beneficial interest of 30% or more in a tax-exempt PE fund will be deemed to have derived assessable profits in respect of the profits earned by the offshore PE fund from specified transactions and incidental transactions in Hong Kong.

However, the deeming provisions will not be applied if the Commissioner is satisfied that beneficial interests in the offshore PE fund are "bona fide widely held". A "bona fide widely held" fund generally means a fund has no less than 50 investors and not less than 21 investors hold 75% or more of the income or property of the fund.

PE funds by their nature are unlikely to be widely held. If the investors of a PE fund include sovereign wealth fund, pension fund and other bona fide widely held fund investor, each of them will be regarded as one investor of the PE fund. Having sovereign wealth fund, pension fund and any other bona fide widely held fund investor will not automatically turn the PE fund into a widely-held investment vehicle.

g) Arm’s Length Fee of Investment Manager

Investment managers and advisors should be adequately remunerated for their services on an arm’s length basis. The IRD considers management and performance fees based on a cost-plus formula are **not** likely to have been determined on the arm’s length basis, in particular when the investment managers or advisors perform significant functions and bear considerable risks in Hong Kong to generate the profits of the offshore funds.

h) Tax Treatment on Performance Fee or Carried Interest

It is quite common that performance fees or carried interest might be structured as a distribution to fund executives through limited partnership arrangement. If a fund executive provides services in Hong Kong, the distributions (unless comparable to the return arising on investments made by external investors in the fund) from the limited partnership would be chargeable to salaries tax as employment income or profits tax as service income if the distributions are not genuine investment returns. The IRD will apply the general anti-avoidance provisions to counteract the tax benefits obtained and bring to charge the fees derived from the provision of management services in Hong Kong.

i) Tax Residence of SPV

As indicated in Part (b) above, the operation of an SPV is very restrictive (i.e. holding and administering EPC in the capacity of a shareholder). As such, the IRD considers the place of residence of the SPV, generally follows that of the offshore PE fund even though the SPV might be incorporated in Hong Kong. Therefore, SPV may not obtain the Hong Kong tax resident status for enjoying the double tax treaty benefits between Hong Kong and other jurisdictions.

The IRD will review whether an SPV has substantial business activities (e.g. whether the SPV has a permanent office or employs staff in Hong Kong to hold and administer its investment in EPC) when considering the SPV’s application for Hong Kong tax resident certificate.

III) OUR COMMENTS

Hong Kong's stock market offers easier exits for PE funds. The IRD has stated in the DIPN 51 that a disposal of an investment by PE funds through IPO would be tax exempted. This may provide comfort to the PE funds that the investment gain on private-equity-backed IPOs would be covered under the tax exemption regime.

Nevertheless, there is still uncertainty on whether an SPV can hold and administer the listed shares of EPC after the IPO. According to the definition of SPVs, they can only hold and administer one or more EPCs. Once an EPC is listed, it becomes a public company and therefore if an SPV continues to hold the listed shares of EPC after IPO, it may violate the SPV requirements under tax exemption. As the IRD considers a PE fund sells its investment in an EPC through an IPO is “in substance no different from a transaction in listed securities or transaction in securities of an EPC”, it may imply that SPV may retain the listed shares of EPC and sell them out at a later stage. However, the IRD has not confirmed this interpretation in the DIPN 51.

Fund industry has a common compensation formula which is generally called “2 and 20”. The fund managers would receive 2% of the fund’s assets each year as a management fee; and 20% of the profits above a hurdle rate as a kind of performance fee or carried interest. The fund managers may also appoint investment advisors in different jurisdictions and pay an advisory fee to these advisors based on a cost-plus formula. The IRD considers advisory fee based on a cost-plus formula are not likely to have been determined on the arm’s length basis. However, if an investment advisor in Hong Kong simply provides investment advices and bears no or minimal risks when providing services for a PE fund/fund manager in Hong Kong, a reward calculated under cost-plus formula may commensurate with its functions performed and risks taken. The IRD should provide more guidance on its view on such arrangement, in particular if the overseas fund managers continue to pay their Hong Kong investment advisors under the cost-plus formula following the general international industry practice.

Hong Kong is widely recognised as a leading fund management centre in Asia with a large concentration of international fund managers. An overwhelming majority of PE funds in Hong Kong came from overseas and invested in companies in the Asia Pacific region. The IRD’s tax treatment on performance fee and carried interest as employment income or service income may be seen as an adverse factor for PE fund managers in considering whether to move to Hong Kong or not. Carried interest arrangement is a common commercial practice in the fund industry. In both US and UK, carried interest would be taxed as capital gain, which generally is subject to a lower tax rate than ordinary employment income. It seems that the IRD is adopting a different view on the nature of carried interest.

In general, fund executives of PE funds are required to travel extensively outside Hong Kong. As indicated in the DIPN 51, the IRD will examine the place where Hong Kong investment managers or advisors rendered their services before deciding whether the carried interest is attributable to their services in Hong Kong and therefore subject to tax in Hong Kong. However, the IRD has not explained clearly the factors which will be taken into consideration when determining the source of their income in this situation.

The IRD may need to further clarify these issues. We will continue to monitor this development and provide our tax update accordingly.

RSM Tax Advisory (Hong Kong) Limited

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- Advise on tax efficient holding and operational structures for new cross-border investment, including the formation of Hong Kong and Chinese business entities
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- Assist clients to discuss and clarify matters with tax officials, including transfer pricing and advance rulings
- Act as client representative in tax audits and tax investigations
- Provide transaction support services on mergers and acquisitions, including tax due diligence, deal structure advice, tax health checks, related human resources arrangements and other tax compliance and consultation services
- Advise on human resources and structuring employment arrangements in a tax-efficient manner
- Advise on tax equalization schemes
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Mr. Dicky To
T +852 2508 2863
E dickyto@rsmhk.com

Mr. Eric Chen
T +852 2583 1259
E ericchen@rsmhk.com

Ms. Lilian Poon
T +852 2583 1241
E lilianpoon@rsmhk.com

Mr. Samuel Chan
T +852 2583 1242
E samuelchan@rsmhk.com

Mr. Patrick Ho
T +852 2583 1258
E patrickho@rsmhk.com

Mr. Caesar Wong
T +852 2508 2851
E caesarwong@rsmhk.com

Ms. Catherine Tsang
T +852 2583 1256
E catherinetsang@rsmhk.com

Mr. Chan Ka Ho
T +852 2583 1249
E khchan@rsmhk.com

Ms. Joanna Lee
T +852 2583 1317
E joannalee@rsmhk.com

RSM Tax Advisory (Hong Kong) Limited
29th Floor, Lee Garden Two
28 Yun Ping Road
Causeway Bay, Hong Kong
T +852 2598 5123
F +852 2598 7230
E tax@rsmhk.com
www.rsmhk.com