

# Proposals to revise offshore fund and REIT rules - Hong Kong Financial Services Development Council recommendations

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The Financial Services Development Council (FSDC) in Hong Kong issued six new research papers on 18 November 2013, which have been submitted to Hong Kong's Chief Executive, the Honourable CY Leung, for consideration.

Two of these papers contain recommendations of particular importance on proposed changes to the taxation of private equity (PE) funds, and proposed changes to the Hong Kong Real Estate Investment Trust (REIT) market.

### Private equity funds

Although Hong Kong has had an exemption from tax for offshore funds for some years, the exemption has not applied to funds that invest in private companies. As a result, most PE and real estate funds have been unable to take advantage of it. Although most Hong Kong based fund managers have been able to keep their funds outside of the Hong Kong tax net, this has typically involved a degree of complexity in the management process to ensure that certain critical activities are undertaken outside of Hong Kong.

As announced in the last budget, the Hong Kong Government is proposing to extend the offshore funds exemption to cover investments in private companies. The original announcement suggested that any fund investing in a Hong Kong company, Hong Kong real estate or a company doing business in Hong Kong, would not be able to benefit from the extended exemption. FSDC Research Paper No. 6 "Synopsis Paper Proposing Tax Exemptions and Anti-avoidance Measures on Private Equity Funds in the 2013-14 Budget" ("the PE paper") recommends that these exclusions be relaxed so that only Hong Kong real estate and companies holding Hong Kong real estate will be restricted. Further, Hong Kong incorporated SPVs used as intermediate holding companies will also be exempted from Hong Kong tax provided they are owned by an exempt fund.

This is a welcome development, which would better reflect how PE funds are structured. In particular, it is often important that they have sufficient substance in Hong Kong to qualify for treaty relief, so it is pleasing to see that not only is it proposed that the existence of Hong Kong entities in the fund would not prevent the relief from applying, but also that they would themselves be exempt from tax. It is, however, interesting to note that the SPV exemption would only apply to Hong Kong incorporated companies, so other companies may still need to consider whether they are carrying on business in Hong Kong. This could be relevant where BVI or Cayman Island companies are used in a structure because of their more flexible dividend and share redemption laws. While some of these concerns may diminish with the revised Companies Ordinance, offshore companies are likely to continue to retain some advantages and historic companies will, in any case, remain in use.

It appears the blanket exemption on real estate may also be lifted, although further clarity may be needed regarding the details. A footnote on page 1 of the PE paper suggests that real estate funds or REITs will not benefit from the new changes, but details on page 2 onwards indicate that the restrictions only apply to direct and certain indirect holdings of Hong Kong real estate. Further, where a portfolio company has an interest in Hong Kong real estate, which is less than 10 percent of its net asset value, it is proposed that this would not prevent the exemption from applying to the fund. Breaches of the 10 percent threshold because of revaluations would not automatically cause the exemption to cease.

This exemption may have limited effect for real estate funds. The effect seems to

be that real estate funds investing only in property outside Hong Kong can be managed from Hong Kong and qualify for the exemption, but that significant ownership of a single Hong Kong property will cause the whole fund to become subject to normal tax rules. This would make it unattractive for any multinational real estate fund with Hong Kong management to invest in Hong Kong real estate. We would prefer to see a carve out from the exemption for profits arising from Hong Kong real estate so that the normally applicable tax rules apply, without the carve out affecting the entitlement to an exemption for the non-Hong Kong assets.

The PE paper also suggests that there may be some relaxation of the need for the manager to be a regulated entity. The timing of the changes is not outlined and there is a suggestion that some of the more important changes may only be addressed as part of a Phase 2, including relaxation of the regulation requirements and the extension of the exemption to all private companies regardless of where they are incorporated or what business they undertake (presumably excluding Hong Kong real estate investment). Since the PE paper already contains a great deal of guidance on these points, we would hope that they will not be delayed long as they are important to the effective implementation of the revised offshore funds regime.

### **H-REITs**

As noted in the FSDC Research Paper No. 4 "Developing Hong Kong as a Capital Formation Centre for Real Estate Investment Trusts" ("the REIT paper"), Hong Kong REITs have not taken off as well as in other markets due to the restrictive nature of the regime. The paper contains a number of proposals designed to make the regime more attractive.

1. Amend the categorisation of H-REITs for MPF purposes to allow MPF schemes to invest more than 10 percent of their total scheme funds in H-REITs.
2. Relax some of the restrictions on development activities by H-REITs; for example, to allow them to acquire an asset that is designed and built according to their specific needs. Such a development should be limited to 10 percent of total assets and needs to be held for at least two years following completion. While a less restrictive policy on development may encourage more REITs, care will be needed to not refuel the property market or significantly increase the level of risk in the REIT returns.
3. Changes are proposed to allow for the compulsory acquisition of certain minority interests on a takeover to reflect the rules currently in place for companies. Minority unit holders are also to be accorded the same protection as shareholders in listed companies.
4. The REIT paper recognises that the current tax regime gives no benefit to H-REITs unlike the common practice in most other REIT regimes. The narrative is a little confusing as H-REITs are already exempt from profits tax as widely held investment trusts, but are not exempt from property tax. As a result, they are forced to invest in property through SPVs, which enjoy no special tax benefits. Consequently, the proposed amendment of exempting H-REITs from profits tax seems only to reinforce the status quo. Nonetheless, we are pleased that the issue has been recognised but we recommend that a more effective measure would be either to exempt the H-REIT from property tax, or alternatively, extend the profits tax exemption to any company that is wholly owned by the H-REIT and fulfils similar criteria to the H-REIT in terms of the way it conducts its business.
5. The REIT paper also contains a proposal to exempt H-REITs from stamp duty on non-residential property transactions. Currently, most H-REITs pay little stamp duty as they effect property purchases through corporate acquisitions, although the attraction of doing this is to some extent a reflection of the deficiencies in the direct tax regime making direct holding of property by the H-REIT unattractive. In the event that the H-REIT exposure to property tax is removed, then removing stamp duty on transfer to a H-REIT is a sensible incentive to foster the creation of H-REITs. However, given the sensitivity of the existing proposed stamp duty revisions, we expect that in the current environment, this may find little favour with the government.

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While the tax recommendations may need some revisions, it is pleasing to note that the Financial Services Development Council recognises the need for modifications to encourage the development of REITs in Hong Kong and the REIT paper provides a useful platform for starting this process.