

HONG KONG TAX ALERT

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New Private Equity Fund tax exemption is good news for Hong Kong's Asset Management Industry

Legislation expected to be enacted during 2015

Summary

- *New PE fund tax exemption expected to be legislated by the Government in 2015*
- *For offshore PE funds, new rules to exempt gains on investments in offshore private companies from Hong Kong profits tax*
- *Under the new rules, Hong Kong SPVs held by PE funds will be exempt from Hong Kong profits tax in respect of gains made from offshore investments. Going forward, this should actively promote the use of Hong Kong SPVs as a platform to hold offshore investments.*

Hong Kong's position as Asia's leading hub for Private Equity (PE) should be given a significant boost once the Government legislates the proposed new PE fund tax exemption in 2015. The Hong Kong Government recently completed industry consultation in relation to these proposed changes.

The new rules are designed to exempt offshore PE funds from tax in Hong Kong in respect of investments made outside of Hong Kong. The changes are also expected to contain an exciting development to promote the use of Hong Kong companies as an investment holding platform. SPVs established in Hong Kong to hold offshore investments should be exempt from tax in Hong Kong on the investment returns made by a PE fund. This is something which the industry has been seeking for some time, and the proposed changes are likely to be wider reaching than an equivalent exemption which applies in Singapore.

The proposed changes were initially announced by the Financial Secretary in his 2013/14 budget speech. It is expected that draft legislation will be introduced to the Legislative Council in coming months.

We have highlighted below the details of the expected changes, what these changes mean for PE funds operating in Hong Kong and what the PE industry should be doing to prepare for these changes.

Existing Offshore Funds tax exemption

Hong Kong's existing Offshore Funds tax exemption has been in place since 2008 and generally works well for hedge funds which operate in Hong Kong. However, for PE funds, the existing exemption has not been as effective because the exemption did not apply to investments in private companies.

Briefly the qualifying conditions for the existing offshore funds tax exemption include:

- The fund is a non-resident fund;
- The profits of the fund result from transactions in specified (section-type) transactions or transactions incidental to specified transactions; and
- The transactions are carried out through or arranged by a specified person

Where all of the qualifying conditions are satisfied, the investment profits of the offshore fund would be exempt from Hong Kong profits tax.

The existing requirements contain a few key limitations which affect the ability of PE funds to rely on the exemption. In particular, gains from investments in private companies are not covered by the exemption.

A further limitation is that the investments need to be arranged by a person licensed with the Securities and Futures Commission (SFC) of Hong Kong. In practice, many PE funds are not required to obtain an SFC license so would need to enter into an arrangement with a licensed person in order to satisfy this requirement.

Expected changes

Following the completion of the consultation process, it is expected that the current exemption will be broadened to cover most types of transactions entered into by PE funds. The key changes proposed by the Government include:

- Amending the scope of the exemption to cover transactions in private companies incorporated outside of Hong Kong
- Waiving the requirement for transactions to be carried out through or arranged by a person with an SFC license, if the PE fund is a bona fide private equity fund
- Extending the scope of the offshore funds exemption to cover profits from investments made by SPVs owned by an offshore PE fund, including SPVs established in Hong Kong

We comment on each of these changes below.

- ***Transactions in private companies***

The current exemption will be expanded to cover a broad range of private companies.

An investment in a private company incorporated outside of Hong Kong will be covered by the exemption, unless one of the following applies at any time in the three years prior to the relevant disposal of securities in that company:

- The private company carried on business in Hong Kong through a permanent establishment;
- The private company directly or indirectly held equity interests in one or more private companies which carried on business in Hong Kong through a permanent establishment and the aggregate value of those equity interests was more than 10% of the value of the private company's total assets; or
- The private company held real estate in Hong Kong, or the private company directly or indirectly held equity interests in one or more private companies' with direct or indirect holdings of real estate in Hong Kong; in addition, the aggregate value of the Hong Kong real estate held by the private company plus the value of the equity interests held in the other private companies exceeded 10% of the value of the private company's total assets

Exempt investments in private companies includes investments in shares, stocks, debentures, loan stocks, funds, bonds or notes. As such, this should be broad enough to cover most types of transactions typically entered into by PE funds, including many debt and hybrid debt/equity investments issued by companies.

- ***Bona fide private equity fund***

Officials have acknowledged that a significant proportion of Hong Kong based investment advisors to offshore PE funds are not licensed with the SFC as they do not fall within the licensing regime. As such, if the exemption required PE funds to be licensed by the SFC when in fact they do not need to be, this would create an un-level playing field across the PE industry.

As result, the Government is looking to introduce the concept of a *bona fide* private equity fund. This definition should capture most genuine PE funds being defined as an offshore PE fund which at the final close of the fund has more than 5 investors (associates being aggregated) which collectively have committed more than 90% of the capital of the fund. In addition, the originator of the funds (and their associates) should not be entitled to receive more than 30% of the net proceeds arising from transactions of the fund. Funds which satisfy these requirements would not need to have transactions carried out through or arranged by a person with an SFC licence in order to benefit from the offshore funds exemption.

- ***SPVs***

Perhaps the biggest opportunity for Hong Kong under the new PE fund exemption will be the ability for PE funds to use Hong Kong companies as an investment holding platform for holding their offshore investments. This will enable PE funds to make use of the substance that they already have in Hong Kong to use Hong Kong as an investment holding jurisdiction. The changes proposed in relation to SPVs represent a significant development which should help to level the playing field with Singapore when PE funds are looking at jurisdictions in which they choose to establish investment platforms. They are also complementary with the efforts being made by Hong Kong to expand Hong Kong's double tax treaty network and promote Hong Kong as an investment holding jurisdiction.

During industry consultation, officials have acknowledged that SPVs are commonly used by PE funds when structuring investments and that exit events can often involve a sale by an SPV instead of by the fund itself. They have agreed that the offshore funds exemption should also apply to both profits derived by an SPV from an investment in a private company and profits derived by an offshore fund from the disposal of an SPV which holds an investment in a private company.

It is expected that SPV will be defined quite broadly to include corporations, partnerships, trustees and non-corporate bodies. However, the SPV would need to be owned by a non-resident, be established only for the purpose of investing in private companies and would not be able to carry on any other trade or activity.

Importantly, an eligible SPV can include a Hong Kong incorporated company. This is a key change as such companies are already commonly used by PE funds to hold investments in China and are gradually being used more frequently to hold investments in other countries as the Government expands Hong Kong's double tax treaty network.

KPMG Comment

The imminent changes represent a positive step forward by the Government and should help to strengthen Hong Kong's status as the premier international asset management centre in Asia.

We also congratulate the Government on the approach that they have taken throughout the industry consultation process. The initial approach that officials were looking to adopt to implement the changes announced by the Financial Secretary contained some limitations which would have continued to have made it difficult for some PE Funds to rely on the revised offshore funds exemption. However, it is clear that officials have listened to feedback from industry participants and it is expected that the draft legislation to be introduced to the Legislative Council will address many of the initial deficiencies.

For a number of years the Hong Kong PE fund industry has been at a competitive disadvantage when compared to other fund centres (in particular Singapore) as there has not been a specific tax exemption that has clearly applied to offshore PE funds with deal teams based in Hong Kong. As a result, investment professionals and private equity funds have had to follow onerous operating protocols in order to prevent the investment returns of the fund that they represent being taxed in Hong Kong. For example, carefully determining the make-up of Investment Committees / Boards, ensuring that investment committee and board meetings are held offshore, carefully monitoring investment related tasks which can / cannot be performed in Hong Kong, etc.

The key benefit of the expected changes is that it will provide investment professionals based in Hong Kong with greater flexibility as to how they undertake their daily tasks without the concern that they may create a tax exposure in Hong Kong for the fund that they represent. This is something that will no doubt be welcomed by many deal teams across town.

We would recommend that funds operating in Hong Kong start considering changes which can be made in anticipation of the pending legislation. This may include:

- Considering what changes can be made to existing operating protocols and when those changes should be implemented
- Revisiting existing fund structures to determine whether there is scope to amend and simplify those structures.
- Preparing or updating transfer pricing support documentation for fees paid to Hong Kong investment advisors to reflect activities which are intended to be performed in Hong Kong going forward

Ultimately, it will be important to see the content of the final legislation. However, it is expected that some initial steps will be able to be taken by funds pending the legislation being enacted.

How can KPMG help?

KPMG has a dedicated team of tax professionals focussed on servicing private equity clients who have been actively involved in the Government consultation process and have extensive experience in assisting clients to establish offshore PE Fund structures. Our team would be pleased to meet with you to discuss the impact of the changes on your business and what you can look to do in the lead-up to these changes coming into effect.

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