

Inland Revenue (Amendment) (No. 2) Ordinance 2015 to Extend Profits Tax Exemption for Offshore Funds to Private Equity Funds Gazetted

Introduction

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The Inland Revenue (Amendment) (No. 2) Ordinance 2015 (Amendment Ordinance) to extend the profits tax exemption to offshore private equity (PE) funds was gazetted on 17 July 2015 and came into operation on the same day. The tax extended exemption is seen as a positive move by the Hong Kong Government to make it more attractive for PE funds to set up and expand their business operating in Hong Kong.

Background

The Inland Revenue Ordinance was amended in 2006 to provide for profits tax exemption to offshore funds, and in particular benefitted hedge funds. Under the exemption provisions of the Revenue (Profits Tax Exemption for Offshore Funds) Ordinance 2006, non-resident entities are exempt from 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".

Under the 2006 Ordinance, offshore PE funds that make use of the services of "specified persons" to

derive profits from transactions in securities of private companies could be subject to Hong Kong profits tax, because the definition of "securities" did not generally include securities of a private company. In addition, offshore PE funds would not qualify for the profit tax exemption if they were not managed by corporations or authorised financial institutions (FI) licensed or registered by the Securities and Futures Commission (SFC).

Key Changes

Definition of "Securities"

The definition of "securities" has been amended such that a transaction in securities in an eligible private company will not be excluded from a "specified transaction", and so can fall within the tax exemption. To qualify for tax exemption the portfolio company should be a private company incorporated outside Hong Kong and, subject to a de minimis requirement, must not hold any Hong Kong real estate or carry out any business in Hong Kong within a stipulated time limit.

Qualified PE funds

Offshore funds will be eligible for profits tax exemption in respect of

profits derived from specified transactions provided the transactions have been carried out through an SFC-licensed/registered corporation or authorised FI (i.e. a "specified person"), or if the offshore fund is a "qualifying" PE fund. The "qualifying" fund concept is new.

A "qualifying" fund means:

- (a) at all times after the final closing of sale of interests -
 - (i) the number of investors exceeds 4; and
 - (ii) the capital commitments made by investors exceed 90% of the aggregate capital commitments; and
- (b) the portion of net proceeds arising from the fund's transactions to be received by the originator (and its associates) must not exceed 30 per cent of the net profits.

SPV exemption

Hong Kong and offshore incorporated special purpose vehicles (SPV) which are wholly or partially owned by an offshore fund are exempted from payment of tax for profits derived from transactions in securities in an

interposed SPV or an eligible offshore private company.

Implications

This is a positive move by the Government to further strengthen Hong Kong as a major asset management hub. The PE fund industry no doubt welcomes the

changes as PE managers can now perform more asset management activities in Hong Kong without the risk of burdening their offshore PE funds with Hong Kong profits tax.

However, many private equity firms are currently unregulated in Hong Kong as they take advantage of the exception available to them by only

giving advice to their 100% owned group companies. If PE managers will start to perform asset management activities out of Hong Kong they will need to consider whether a Type 9 (asset management) license is required.

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