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Hong Kong Financial Services Development Council issues proposal on private equity funds

Executive summary

This Alert discusses the proposals made by the Financial Services Development Council (FSDC)[1] to exempt nonresident private equity funds (PE funds) in Hong Kong.

The FSDC's proposal suggests that, in addition to exempting nonresident PE funds themselves from Hong Kong taxation, the Hong Kong-incorporated special purpose vehicles (SPVs) employed by PE funds would also be tax-exempt in Hong Kong. In addition, the threshold for determining whether a nonresident fund is "bona fide widely held" is suggested to be lowered from the current practice of 50 persons to 5 persons for PE funds.

Detailed discussion

Background

Under the Profits Tax Exemption for Offshore Funds Ordinance (Ordinance) enacted in 2006, all nonresident persons are exempt from tax in Hong Kong if their activities in Hong Kong are restricted to "specified transactions" and transactions incidental to the "specified transactions" (Safe Harbor Rule). However, transactions in shares of a private company are not included in the "specified transactions."

The 2013/14 Budget proposed in February this year includes an extension of the Safe Harbor Rule to transactions in private companies. Under the proposal, such private companies must be incorporated or registered outside Hong Kong and not hold any Hong Kong properties or carry out any business in Hong Kong.

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Extended Safe Harbor Rule
The FSDC has proposed that the Safe Harbor Rule should cover a PE fund where the PE fund invests directly into private companies (portfolio companies) which are incorporated or registered outside of Hong Kong, not carrying on any business in Hong Kong or holding any Hong Kong real estate (Extended Safe Harbor Rule). The Extended Safe Harbor Rule should continue to apply to portfolio companies that meet the "10% de minimis exemption threshold," i.e., its incidental investment in Hong Kong real estate is of less than 10% of its net asset value.

In addition, the FSDC has proposed that, in the case where the PE fund invests into portfolio companies via one or more Hong Kong incorporated SPVs, such SPVs be exempt from taxation in Hong Kong provided that certain conditions are met.

Proposed changes to the Deeming Provisions to cater for PE funds
Under the current rules where an offshore fund, which is exempt from taxation in Hong Kong under the Safer Harbor Rule, is 30% or more owned by a Hong Kong resident, the Hong Kong resident would be deemed under the Ordinance to have derived assessable profits in respect of the Hong Kong source trading profits earned by the offshore fund (Deeming Provisions). The Deeming Provisions do not apply where an offshore fund is regarded as being "bona fide widely held." The current rule provides that an offshore fund would be regarded as being "bona fide widely held" if at no time did fewer than 50 persons hold (or have the right to become holders of) all of the units or shares in the offshore fund, provided that certain other conditions are also met.

The FSDC has proposed that the Deeming Provisions not be invoked in cases where at no time did fewer than 5 persons hold (or have the right to become holders of) all the partnership interest of a PE fund, as opposed to the current approach of 50 persons.

Implications

The proposed exemption of SPVs under a PE fund would facilitate the use of Hong Kong's expanding network of tax treaties by such SPVs; whereas SPVs cannot be included in the current regime for exempting nonresident offshore funds. Furthermore, it appears that the proposed exemption would not be restricted to Hong Kong incorporated SPVs only.

The FSDC's proposal that a PE fund that was at no time held by fewer than five persons would be regarded as being "bona fide widely held" for the purposes of the Deeming Provisions, is less onerous given the majority of PE funds are in the form of limited partnerships.

Endnote

1. The Financial Services Development Council (FSDC) was established by the HKSAR Government in January 2013 in response to the financial services industry's aspiration for a high-level government advisory body to support the sustained development of the industry. The FSDC engages the industry and formulates proposals to promote the further development of Hong Kong's financial services industry and map out the strategic direction for the development of Hong Kong as an international financial center. It acts as a focal point of views, a melting pot of ideas, champion and ambassador of the industry, and a capacity builder.

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