



Hong Kong

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EXTENSION OF PROFITS TAX EXEMPTION TO OFFSHORE PRIVATE EQUITY FUNDS IN 2015

The Revenue (Profits Tax Exemption for Offshore Funds) Ordinance was enacted in 2006 to provide profits tax exemptions to offshore funds. In 2015, the Inland Revenue (Amendment) (No. 2) Ordinance 2015 (the **2015 Ordinance**) was enacted to extend the profits tax exemption to offshore private equity funds.

Profits tax exemption prior to the 2015 Ordinance

Prior to the enactment of the 2015 Ordinance, the profits tax exemption for offshore funds was only available to non-resident funds provided that:

- the funds' profits arose from "specified transactions" or transactions that were incidental to specified transactions; and
- the transactions were carried out through, or arranged by, "specified persons" (i.e. corporations licensed and authorised financial institutions registered with the Securities and Futures Commission (**SFC**) under the Securities and Futures Ordinance (Cap. 571 of Laws of Hong Kong) (**SFO**) to carry out such transactions).

"Specified transactions" were broadly defined in the Inland Revenue Ordinance (Cap. 112 of Laws of Hong Kong) (the **IRO**) to include transactions in securities, futures contracts, foreign exchange contracts, foreign currencies, exchange-traded commodities and transactions consisting in the making of deposits other than by way of a money-lending business.

However, specified transactions did not include transactions in private companies' securities as these were not covered by the definition of "securities" in the IRO. This means that offshore private equity funds that derived profits from investments in private companies could not enjoy the exemption. Moreover, offshore private equity funds are not necessarily managed by corporations licensed or authorized financial institutions registered with the SFC under the SFO, which was another condition of the exemption.

Major amendments to the IRO in the 2015 Ordinance

The major amendments to the IRO in the 2015 Ordinance are as follows:

- I. **Amendment of the definition of "securities" in the IRO** to include interests such as shares and debentures of, or issued by excepted private companies or special purpose vehicles (**SPVs**).
- II. **Exemption of a non-resident person¹ that is a qualifying fund** from profits tax in respect of assessable profits of the fund arising from specified transactions and transactions incidental to the carrying out of specified transactions;

¹ "Person" in the IRO and this note includes a corporation, partnership, trustee, whether incorporated or unincorporated, or body of persons (see section 2 of Part 1 of the IRO).

- III. **Exemption of certain assessable profit of an SPV** from the payment of tax in respect of its assessable profits arising from transactions concerning an interposed SPV, or an excepted private company.
- IV. **Extension of anti-avoidance deeming provisions to SPVs:** when the fund has a beneficial interest in an SPV that is exempt from the payment of tax in respect of its assessable profits from transactions falling within Section III (a) to (c) of this note, the resident person is deemed to have derived assessable profits in respect of profits earned by the SPV.
1. it neither held immovable property in Hong Kong, nor held (whether directly or indirectly) share capital (however described) in one or more private companies with direct or indirect holding of immovable property in Hong Kong;
 2. it held such immovable property or share capital (or both), but the aggregate value of the holding of the property and capital is equivalent to not more than 10% of the value of its own assets.

Profits derived from the disposal of private companies not fulfilling the above conditions will not be subject to profits tax if they are capital in nature or are derived from operations outside Hong Kong.

I. Extension of the definition of “securities”

The definition of “securities” set out in Schedule 16 to the IRO was extended by the 2015 Ordinance to include interests such as shares and debentures of, or issued by (i) an excepted private company and (ii) an SPV.

(i) Excepted private company

An offshore private equity fund deriving profits from transactions in securities of an excepted private company can enjoy the tax exemption. An excepted private company is a private company incorporated outside Hong Kong, which at all times within the three years before a transaction in securities of the SPV or private company:

- a) did not carry on business through or from a permanent establishment in Hong Kong;
- b) falls within either of the following descriptions -
 1. it did not hold (whether directly or indirectly) share capital (however described) in one or more private companies carrying on any business through or from a permanent establishment in Hong Kong;
 2. it held such share capital, but the aggregate value of the holding of the capital is equivalent to not more than 10% of the value of its own assets; and
- c) falls within either of the following descriptions -

(ii) SPV

Private equity funds usually set up one tier or multiple tiers of SPVs to hold their private companies. This facilitates the subsequent disposal of such companies by way of transferring the ownership interests in SPVs. With the extended definition of “securities” in the IRO, offshore private equity funds are exempt from tax in respect of profits derived from a disposal of interests, such as shares or debentures, in an SPV. To qualify for tax exemption, an SPV must be a corporation, partnership, trustee of a trust estate or any other entity that:

- a) is wholly or partially owned by a non-resident person (i.e. an offshore fund);
- b) is established solely for the purpose of holding, directly or indirectly, and administering one or more excepted private companies;
- c) is incorporated, registered or appointed in or outside Hong Kong;
- d) does not carry on any trade or activities except for the purpose of holding, directly or indirectly, and administering one or more excepted private companies; and
- e) is not itself an excepted private company.

II. Extension of profit tax exemption to offshore qualifying funds

Previously, the profits tax exemption required transactions to be carried out through or arranged by a corporation licensed or an authorised financial institution registered with the SFC. The 2015 Ordinance extended the tax exemption to transactions that are carried out by an offshore qualifying fund.

A qualifying fund is a fund:

- a) which has more than four investors other than the originator (which is defined as a person who originates or sponsors the fund and has the power to make investment decisions on behalf of the fund) or the originator's associates;
- b) which has capital commitments made by such investors exceeding 90% of the aggregate capital commitments; and
- c) which the portion of the net proceeds arising out of the transactions of the fund to be received by the originator and the originator's associates, after deducting the portion attributable to their capital contributions (which is proportionate to that attributable to the investors' capital contributions), is agreed under an agreement governing the operation of the fund to be an amount not exceeding 30% of the net proceeds.

III. Exemption for certain profits of an SPV

For any year of assessment commencing on or after 1 April 2015, the IRO, amended by the 2015 Ordinance, exempts an SPV, to the extent corresponding to the percentage of shares or interests held by the offshore private equity fund, from payment of tax in respect of assessable profits arising from:

- a) transactions in shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, an interposed special purpose vehicle (e.g. an SPV indirectly owned by a non-resident person) or an excepted private company;
- b) transactions in rights, options or interests (whether described as units or otherwise) in, or in respect of, such shares, stocks, debentures, loan stocks, funds, bonds or notes; and

- c) transactions in certificates of interest or participation in, temporary or interim certificates for, receipts for, or warrants to subscribe for or purchase, such shares, stocks, debentures, loan stocks, funds, bonds or notes.

IV. Extension of anti-avoidance deeming provisions to SPVs

The anti-avoidance deeming provisions prior to the 2015 Ordinance continue to cover Hong Kong resident owners of offshore funds. When a resident person, either alone or jointly with his associates, holds a beneficial interest of 30% or more in a tax-exempt offshore private equity fund, or any percentage if the offshore private equity fund is the resident person's associate, the resident person is deemed to have derived assessable profits in respect of the profits earned by the fund from the specified transactions and incidental transactions carried out in Hong Kong.

The 2015 Ordinance introduced similar deeming provisions to the profits of SPVs. When the fund has a beneficial interest in an SPV that is exempt from the payment of tax in respect of its assessable profits from transactions falling within Section III (a) to (c) of this note, the resident person is deemed to have derived assessable profits in respect of profits earned by the SPV.

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Hong Kong Office

Dominion Centre

12th Floor

43-59 Queen's Road East

Hong Kong

Tel: + (852) 2905 7888

Fax: + (852) 2854 9596

www.charltonslaw.com