



Inland Revenue Department
Hong Kong

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 51

PROFITS TAX

PROFITS TAX EXEMPTION FOR OFFSHORE PRIVATE EQUITY FUNDS

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the laws as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

WONG Kuen-fai
Commissioner of Inland Revenue

May 2016

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

No. 51

CONTENT

	Paragraph
Introduction	
Relevant legislation	1
Private equity funds	
Nature of private equity funds	2
Fund lifecycle	3
Fund structure	5
Before the 2015 Ordinance	
Specified transactions and specified person	6
Securities of private companies excluded	8
The 2015 Ordinance	
Aim of amendment ordinance	10
Exemption extended to private equity funds	
Expanded definition of securities	12
Special purpose vehicle	14
Excepted private company	16
- Definition of private company	17
- Three-year time frame	19
- Safe harbour rules	20
- Permanent establishment of private company	28
Funds not engaging a specified person	
Qualifying fund	33
Number of investors	40
Capital commitment	41
Net proceeds	42

Special Purpose Vehicle	
Exempt from tax payment	46
Interposed SPV	51
Loss from exempt transactions	
Tax treatment	55
Anti-abuse provisions	
Resident person with 30% or more interest	56
Ascertainment of deemed profits	59
Deeming provisions not applicable	67
Reporting requirements	71
Taxation of investment manager	
Arm’s length fee	72
Performance fee or carried interest	73
Tax avoidance	
General anti-avoidance provisions	77
Tax Residence	
Tax residence of private equity funds	79
Tax residence of SPV	80
Appendix	
Typical offshore private equity fund structure	

INTRODUCTION

Relevant legislation

The Revenue (Profits Tax Exemption for Offshore Funds) Ordinance 2006 was enacted to provide profits tax exemption to offshore funds while the Inland Revenue (Amendment) (No. 2) Ordinance 2015 (the 2015 Ordinance) was enacted to extend the profits tax exemption for offshore funds to offshore private equity funds. This Note sets out the Department's interpretation and practice in relation to the relevant provisions under the 2015 Ordinance which are mainly applicable to offshore private equity funds. Reference should also be made to Departmental Interpretation and Practice Notes No. 43 (Revised) (Profits Tax Exemption for Offshore Funds) (DIPN 43) since it covers the interpretation and practice relating to the offshore fund regime as a whole. Unless specified otherwise, all the provisions quoted herein refer to the Inland Revenue Ordinance (the Ordinance).

PRIVATE EQUITY FUNDS

Nature of private equity funds

2. Private equity funds are almost always closed ended vehicles. They provide finance in return for an equity stake in potentially high growth private companies. They are privately marketed and funded by capital raised outside the public markets. Private equity funds are pooled investment vehicles, usually structured with a finite investment period. Sources of capital include pension funds, sovereign wealth funds, funds of funds, insurance companies etc.

Fund lifecycle

3. Private equity funds typically invest in private companies for around 5 to 7 years. This means a commitment to building sustainable and lasting value in the business they invest in. The way to realize returns is to sell the business in better shape than when it was acquired. Typically private equity funds will sell their stake in a private company by listing on the public markets or selling to a strategic buyer.

4. Private equity funds typically look to invest directly or indirectly, via a special purpose vehicle (SPV), majority stakes in private companies by purchase of shares from the existing shareholders or through the subscription of new shares. Growth in the business is delivered by working with the management team of the private company to improve performance and strategic direction, making complimentary investments and driving operational improvements. In the exit strategy, there will be criteria for what needs to be achieved before resale and there will be periodic reviews of strategy.

Fund structure

5. Limited partnership is the most common private equity fund vehicle. Complex and multi-vehicle fund structures, including parallel funds and master-feeder structures, may be used in order to accommodate the preferences of fund investors. A typical limited partnership structure is depicted in the **Appendix**.

BEFORE THE 2015 ORDINANCE

Specified transactions and specified person

6. Before the enactment of the 2015 Ordinance, non-resident persons, including individuals, partnerships, trustees of trust estates or corporations, were exempt from tax in respect of profits derived from “specified transactions” carried out through or arranged by a “specified person” and from “transactions incidental to the carrying out of specified transactions”. The non-resident person could not carry on any trade, profession or business in Hong Kong other than the specified transactions as defined in Schedule 16 to the Ordinance and transactions incidental to the carrying out of the specified transactions.

7. “Specified transactions” were broadly defined in Schedule 16 to cover typical transactions carried out by offshore funds in Hong Kong. Schedule 16 contained six categories of specified transactions: a transaction in securities; a transaction in futures contracts; a transaction in foreign exchange contracts; a transaction consisting in making a deposit other than by way of a money-lending business; a transaction in foreign currencies; and a transaction in exchange-traded commodities. “Specified persons” as defined in section

20AC(6) included corporations licensed and authorized financial institutions registered under the Securities and Futures Ordinance (Cap. 571) for carrying on a business in any regulated activity as defined by Part 1 of Schedule 5 to that Ordinance.

Securities of private companies excluded

8. The definition of “securities” in Schedule 16 did not include securities of a private company. In other words, offshore private equity funds that made use of the service of a “specified person” to derive profits from transaction in securities of private companies could be subject to profits tax. Nevertheless, private equity business might not necessarily be managed by corporations licensed or authorized financial institutions registered under the Securities and Futures Ordinance.

9. Offshore private equity funds might use asset management and ancillary professional services, such as services for launching, fund-raising, closing, structuring, documentation, investing, ongoing managing, divestment and distribution, in Hong Kong. This could thus render the profits derived from transactions in securities of private companies outside Hong Kong subject to profits tax in Hong Kong.

THE 2015 ORDINANCE

Aim of amendment ordinance

10. The 2015 Ordinance was passed in July 2015 to extend the profits tax exemption for offshore funds to offshore private equity funds. By providing clear profits tax exemption to transactions conducted by offshore private equity funds in respect of eligible overseas private companies, more private equity fund managers are expected to expand their business in Hong Kong and more offshore private equity fund managers are attracted to set up or expand their business in Hong Kong, thereby generating demand for local asset management, investment and advisory services, as well as other relevant professional services.

11. The main provisions of the 2015 Ordinance are as follows:

- (a) Section 20AC is amended to -
 - (i) exempt a non-resident person that is a qualifying fund from profits tax in respect of assessable profits of the person arising from specified transactions and transactions incidental to the carrying out of specified transactions;
 - (ii) provide that section 20AC does not apply to an SPV; and
 - (iii) provide for the application of the amended section 20AC to such transactions carried out within the period from 1 April 2015 to 16 July 2015 (i.e. the day before that date of commencement of the 2015 Ordinance).
- (b) Section 20ACA is added to exempt an SPV, which may be a resident person or a non-resident person, from the payment of tax in respect of its assessable profits arising from transactions concerning an interposed SPV, or an excepted private company, as defined by that section.
- (c) Section 20AF is added to provide that in certain circumstances, the assessable profits of an SPV, held by a non-resident person and exempt from the payment of tax under the new section 20ACA, are to be regarded as the assessable profits of a resident person.
- (d) Definition of “securities” in section 1 of Part 2 of Schedule 16 is amended to include interests such as shares and debentures of, or issued by, SPVs or excepted private companies.

EXEMPTION EXTENDED TO PRIVATE EQUITY FUNDS

Expanded definition of securities

12. The 2015 Ordinance has amended the definition of “securities” in Schedule 16 to the Ordinance so that a transaction in securities of an SPV or an excepted private company is a “specified transaction”. Currently, the term “securities” means:

- (a) subject to section 21(6) of Schedule 17A (specified alternative bond scheme and its tax treatment), shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a body, whether incorporated or unincorporated, or a government or municipal government authority (excluding shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a private company which is not an SPV or an excepted private company);
- (b) 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;
- (c) 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;
- (d) interests in any collective investment scheme;
- (e) interests, rights or property, whether in the form of an instrument or otherwise, commonly known as securities.

13. This definition of “securities” applies to specified transactions carried out from 1 April 2015 onwards. The new scope of “securities” should be able to cover most of the relevant instruments, such as debentures, loan stocks, funds, bonds or notes issued by SPVs or excepted private companies, including hybrid instruments which are used to structure private equity investments.

Special purpose vehicle

14. Private equity funds generally 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 new definition of “securities” in section 1 of Part 2 of Schedule 16, offshore private equity funds are exempt from tax in respect of profits derived from a transaction in: shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by an SPV; rights, options, or interests (whether described as units or otherwise) in an SPV; or certificates of interest or participation in or warrants to subscribe for or purchase an SPV. The transaction refers to the disposal of securities of 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.

15. The definition in section 20ACA explicitly excludes an SPV which has been engaged in any trade or activities apart from holding, directly or indirectly, and administering one or more excepted private companies.

Example 1

In January 2008, Company HK was incorporated as a private company to hold properties in Hong Kong. Fund F1, resident in

Jurisdiction F1, held all the shares in Company HK. In December 2010, Company HK became dormant after the disposal of its properties. In January 2011, Fund F1 made use of Company HK to acquire Company F2, an excepted private company incorporated and resident in Jurisdiction F2. In October 2015, Fund F1 sold its shares in Company HK and made a profit.

Fund F1 was not entitled to tax exemption provided under section 20AC in respect of profits derived from the sale of shares in Company HK. Company HK did not qualify as an SPV under section 20ACA since it was not established solely for the purpose of holding and administering Company F2. If the profit from the sale of shares in Company HK was a trading profit derived from operations carried out in Hong Kong, it would be subject to profits tax.

Excepted private company

16. An offshore private equity fund deriving profits from transaction in securities of an excepted private company can enjoy tax exemption. The term “excepted private company” refers to 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 any business through or from a permanent establishment in Hong Kong;
- (b) falls within either of the following descriptions -
 - (i) 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;
 - (ii) 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 -
- (i) 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;
 - (ii) 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 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.

Definition of private company

17. Since the definition of “private company” in section 11 of the Companies Ordinance (Cap. 622)¹ may not be applicable to companies incorporated outside Hong Kong, the term has to be specifically defined. In section 20ACA, “private company” is defined to mean a company incorporated in or outside Hong Kong that is not allowed to issue any invitation to the public to subscribe for any shares or debentures of the company.

18. In deciding whether a company is not allowed to issue invitations to the public to subscribe for its shares or debentures, all circumstances will be examined. If the company is incorporated in Hong Kong, the relevant provisions in the Companies Ordinance will be applied to determine whether the company is a private company (i.e. whether it can issue invitation to the public for capital). If the company is incorporated outside Hong Kong, provisions in overseas legislation, including but not limiting to overseas company legislation, will be applied to determine whether the company is

¹ Under section 11 of the Companies Ordinance (Cap. 622), “private company” means a company which by its articles - (a) restricts the right to transfer its shares; and (b) limits the number of its members to 50, not including persons who are in the employment of the company and persons who, having been formerly in the employment of the company, were while in that employment, and have continued after the determination of that employment to be, members of the company; and (c) prohibits any invitation to the public to subscribe for any shares or debentures of the company.

allowed to issue invitations to the public for capital. If taking additional steps or seeking approval would allow the company to issue invitations to the public but without involving a substantial change to its nature, the company is treated as not prohibited from issuing shares or debentures to the public. In general, neither a listed company nor a non-private unlisted company (i.e. a public company with more than 50 members) would be treated as a “private company”.

Three-year time frame

19. The offshore private equity fund will only qualify for tax exemption if the excepted private company meets all the conditions listed in paragraph 16(a) to (c) above at all times within the three years before the transaction in securities in that company is carried out. The transaction refers to a disposal of securities of or issued by the excepted private company. The three year period counts backward from the date of such a disposal. The three-year time requirement equally applies to the disposal by an SPV of such securities.

Example 2

On 1 October 2010, Limited Partnership F1 resident in Jurisdiction F1 acquired all the share capital in Company F2. Company F2 was incorporated as a private company in Jurisdiction F2 and it closed its accounts on 31 December every year. Company F2 was a holding company, not an SPV, and all the companies it held only had business operations or properties in territories outside Hong Kong. Since 1 October 2010, Company F2 had not carried on any business in Hong Kong nor held any immovable property in Hong Kong. On 1 July 2015, Limited Partnership F1 carried out the transaction in Hong Kong to sell all the shares in Company F2 and made a profit.

Profits derived by Limited Partnership F1 from the sale of shares in Company F2 were exempt from profits tax though the sale transaction was carried out in Hong Kong. Company F2 qualified as an excepted private company since Company F2 and the companies it held did not carry on any business or hold any properties in Hong Kong at all times within the three years before the sale of shares (i.e. from 1 July 2012 to 30 June 2015).

Safe harbour rules

20. The excepted private company cannot carry on a business through or from a permanent establishment in Hong Kong. However, it is allowed to have some insignificant business activities in Hong Kong but the business activities must be of a purely preparatory or auxiliary character and the place of business does not constitute a permanent establishment.

21. The excepted private company may also hold share capital (however described), subject to the 10% safe harbour rule, in one or more private companies carrying on any business through or from a permanent establishment in Hong Kong. The term “share capital (however described)” covers all forms of participation interests or equity interests which entitle the holders to participate in or share profits accrued to a private company, with or without a share capital.

22. In general, the derivation of rental income from the business activities of letting or sub-letting of immovable properties in Hong Kong, whether by the excepted private company or a private company it holds will be regarded as the carrying on of a business through or from a permanent establishment in Hong Kong.

23. The aggregate value of participation interests or equity interests in private companies with a permanent establishment in Hong Kong, held by an excepted private company, cannot exceed 10% of the value of the assets of the excepted private company. The “value of the holding of the capital” in paragraph 16(b)(ii) and (c)(ii) refers to the “market value” and not the “par value” or “nominal value” of the capital. In calculating the value of the total assets of a company, debts of the company including liabilities secured by mortgages on the relevant immovable property are not deducted. Thus the values used in the percentage calculation are in gross amount.

24. The excepted private company is not expected to hold any immovable property of significant value in Hong Kong. This is to prevent local entities from converting trading profits derived from investments in real estate into non-taxable income via an offshore private equity fund structure. It is stipulated that the aggregate value of the immovable property held in Hong Kong by the excepted private company and the “share capital (however

described)” held in other private companies, with direct or indirect holding of property in Hong Kong, cannot exceed 10% of the value of the total assets of the excepted private company.

25. When applying the 10% safe harbour rules, it is necessary to examine the audited financial statements of the excepted private company for the latest three years, supplemented by management accounts up to the date of transaction in securities, to determine:

- (a) the market value of the holding of share capital in the private company carrying on business through or from a permanent establishment in Hong Kong;
- (b) the market value of the holding of immovable property in Hong Kong;
- (c) the market value of the holding of share capital in the private company with direct or indirect holding of immovable property in Hong Kong; and
- (d) the market value of the assets of the excepted private company.

26. The safe harbour rules are meant to be straight forward in their application without imposing too much of a burden on an offshore private equity fund, in particular if the excepted private company has an insignificant amount of share capital in a private company which has immovable properties in Hong Kong. Generally, it may not be necessary to obtain a valuation of the underlying immovable properties since the offshore private equity fund might not be able to request for a valuation of the immovable properties.

27. The value of the holding of share capital in a private company, which is held directly or indirectly by the excepted private company, having a permanent establishment in Hong Kong or with direct or indirect holding of immovable property in Hong Kong, is not affected by the number of private companies interposed in between. Therefore, the question of double or multiple counting the value of the share capital in another private company interposed in between should not arise.

Example 3

On 1 January 2010, Limited Partnership F1 resident in Jurisdiction F1 acquired 50% of the share capital in Company F2. Company F2 was incorporated as a private company in Jurisdiction F2 and it closed its accounts on 31 December every year. At all relevant times, Company F2 held 60% of the share capital in Company HK which was carrying on a trade in Hong Kong. On 1 October 2015, Limited Partnership F1 sold all the shares in Company F2 and made a profit. The financial statements of Company F2 gave the following details:

<i>As at</i>	<i>Market Value of Total Assets of Company F2</i>	<i>Market Value of Shares in Company HK Held by Company F2</i>
<i>31.12.2011</i>	<i>\$1,400m</i>	<i>\$90m</i>
<i>31.12.2012</i>	<i>\$1,500m</i>	<i>\$100m</i>
<i>31.12.2013</i>	<i>\$1,200m</i>	<i>\$120m</i>
<i>31.12.2014</i>	<i>\$1,250m</i>	<i>\$115m</i>

Since it might not be practical for Limited Partnership F1 to provide data for the exact period from 1 October 2012 to 30 September 2015, the available financial statements could be relied upon to perform below calculations:

<i>As at</i>	<i>Market Value of Shares in Company HK Divided by Market Value of Total Assets of Company F2</i>
<i>31.12.2011</i>	$\$90\text{m} \div \$1,400\text{m} = 6.4\%$
<i>31.12.2012</i>	$\$100\text{m} \div \$1,500\text{m} = 6.7\%$
<i>31.12.2013</i>	$\$120\text{m} \div \$1,200\text{m} = 10\%$
<i>31.12.2014</i>	$\$115\text{m} \div \$1,250\text{m} = 9.2\%$

It is necessary to examine the management accounts prepared up to 30 September 2015. If it is satisfied that the market value of shares in Company HK held by Company F2 was equivalent to not more than 10% of the market value of the total assets of Company F2 at all times within the three years (i.e. from 1 October 2012 to 30 September 2015) before the sale of the shares in Company F2, the profit derived by Limited Partnership F1 from the sale of the shares in Company F2 would be exempt under section 20AC.

Example 4

On 1 January 2010, Limited Partnership F1 resident in Jurisdiction F1 acquired 40% of the share capital in Company F2. Company F2 was incorporated as a private company in Jurisdiction F2 and it closed its accounts on 31 December every year. At all relevant times, Company F2 held a property in Hong Kong and an equity interest in Company HK which, was carrying on a trade in Hong Kong. On 1 January 2016, Limited Partnership F1 sold its shares in Company F2 and made a profit. The financial statements of Company F2 gave the following details:

<i>As at</i>	<i>Market Value of Total Assets of Company F2</i>	<i>Market Value of Hong Kong Property Held by Company F2</i>	<i>Market Value of Shares in Company HK Held by Company F2</i>
<i>31.12.2012</i>	<i>\$900m</i>	<i>\$80m</i>	<i>\$8m</i>
<i>31.12.2013</i>	<i>\$1,000m</i>	<i>\$90m</i>	<i>\$10m</i>
<i>31.12.2014</i>	<i>\$1,200m</i>	<i>\$98m</i>	<i>\$12m</i>
<i>31.12.2015</i>	<i>\$1,250m</i>	<i>\$100m</i>	<i>\$15m</i>

Limited Partnership F1 could rely on the available financial statements to perform below calculations:

As at	Aggregate Value of Property and Shares in Company HK as a Percentage of Value of Total Assets of Company F2
31.12.2012	$(\$80m + \$8m) \div \$900m = 9.8\%$
31.12.2013	$(\$90m + \$10m) \div \$1,000m = 10\%$
31.12.2014	$(\$98m + \$12m) \div \$1,200m = 9.2\%$
31.12.2015	$(\$100m + \$15m) \div \$1,250m = 9.2\%$

If it is satisfied that the aggregate market value of the property in Hong Kong and the shares in Company HK was equivalent to not more than 10% of the market value of the total assets of Company F2 at all times within three years (i.e. from 1 January 2013 to 31 December 2015) before the sale of the shares in Company F2, the profit derived by Limited Partnership F1 from the sale of the shares in Company F2 would be exempt under section 20AC.

Example 5

On 1 January 2010, Limited Partnership F1 resident in Jurisdiction F1 acquired 40% of the share capital in Company F2. Company F2 was incorporated as a private company in Jurisdiction F2 and it closed its accounts on 31 December every year. At all relevant times, Company F2 held: a property in Hong Kong; 30% of the share capital in Company HK1 which was carrying on a trade in Hong Kong; and 60% of the share capital in Company HK2. Company HK3 and Company HK4, each of which held a property in Hong Kong, were wholly owned by Company HK2. On 1 January 2016, Limited Partnership F1 sold its shares in Company F2 and made a profit. The financial statements of Company F2 gave the following details:

<i>As at</i>	<i>Market Value of Total Assets of Company F2</i>	<i>Market Value of Hong Kong Property Held by Company F2</i>	<i>Market Value of Shares in Company HK1 Held by Company F2</i>	<i>Market Value of Shares in Company HK2 Held by Company F2</i>
<i>31.12.2012</i>	<i>\$900m</i>	<i>\$80m</i>	<i>\$4m</i>	<i>\$8m</i>
<i>31.12.2013</i>	<i>\$1,000m</i>	<i>\$90m</i>	<i>\$5m</i>	<i>\$10m</i>
<i>31.12.2014</i>	<i>\$1,200m</i>	<i>\$98m</i>	<i>\$7m</i>	<i>\$12m</i>
<i>31.12.2015</i>	<i>\$1,250m</i>	<i>\$100m</i>	<i>\$8m</i>	<i>\$15m</i>

Limited Partnership F1 could rely on the available financial statements to perform below calculations:

As at	Aggregate Value of Property and Shares as a Percentage of Value of Total Assets of Company F2
31.12.2012	$(\$80m + \$4m + \$8m) \div \$900m = 10.2\%$
31.12.2013	$(\$90m + \$5m + \$10m) \div \$1,000m = 10.5\%$
31.12.2014	$(\$98m + \$7m + \$12m) \div \$1,200m = 9.8\%$
31.12.2015	$(\$100m + \$8m + \$15m) \div \$1,250m = 9.8\%$

The aggregate market value of the property in Hong Kong and the shares in Company HK1 and Company HK2 was not, at all times within the three years (i.e. from 1 January 2013 to 31 December 2015) before the sale of the shares in Company F2, equivalent to not more than 10% of the market value of the total assets of Company F2.

Therefore, the profit derived by Limited Partnership F1 from the sale of the shares in Company F2 would not be exempt under section 20AC. For the purpose of calculation, the values of the holding of share capital in Company HK3 and Company HK4 (having immovable properties in Hong Kong), indirectly held by Company F2 via Company HK2, do not need to be taken into account.

Permanent establishment of private company

28. For a private company, a permanent establishment is defined in section 20ACB(1) to mean a fixed place of business through which activities of the company are wholly or partly carried on, including a branch and a place of management. From the definition, it is clear that other places of business may be regarded as a permanent establishment in accordance with the meaning generally adopted in taxation for permanent establishments. The term “place of management” used in the definition usually refers to a place of work or an office where some of the supervisory activities for a private company is exercised. While an office, a factory and a workshop are normally a fixed place of business, they may not necessarily be a place where the business or trade is being managed.

29. It is expressly stated in section 20ACB(2) that if a private company has an agent carrying on activities in Hong Kong, who has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of the private company or has a stock of merchandise from which the agent regularly fills orders on behalf of the company, the company will be deemed to have a permanent establishment in Hong Kong. The agent may not be the final signatory to a contract but if it participates in the negotiations and formulates the contract provisions on behalf of the private company then the private company will still be regarded as having a permanent establishment in Hong Kong.

30. In defining a permanent establishment, section 20ACB(3) excludes a place of business whose activities, for the private company, are purely of a preparatory or auxiliary character. The following activities of a preparatory or auxiliary character may be carried out for the private company without constituting a permanent establishment:

- (a) the use of facilities solely for storage, display or delivery of goods or merchandise belonging to the company;
- (b) the maintenance of a stock of goods or merchandise belonging to the company solely for storage, display or delivery, or for processing by another business; and
- (c) the maintenance of a fixed place of business solely for purchasing goods or merchandise, or for collecting information, for the company.

31. The term “activities” used in section 20ACB is generic and covers both “business activities” and “trading activities”, though the activities themselves may not constitute the “business” or “trade” itself. In general, conduct having the character or essence of a business or trade would involve capital, dealings with other persons, plant and machinery, etc.

32. The formulations in section 20ACB(2)(a) and (b) should be wide enough to cover factors (i.e. mercantile agents) and consignees. Section 20ACB(3)(a) and (b) however excludes delivery activities not involving a stock of merchandise from which an agent regularly fills orders for the company. The formulation of section 20ACB(2)(b) caters for the situation where the company has an “agent” carrying on activities in Hong Kong who has a “stock of merchandise” from which the agent “regularly fills orders” on behalf of the company. The keeping of a stock of merchandise, the presence of an agent and the filling of orders here are the crux of the issue. They imply that active business transactions are involved with the profit derived therefrom subject to taxation. As for section 20ACB(3)(a), the mere “storage, display or delivery” services assume only a passive role and therefore it should be excluded from the business of the company as mentioned in section 20ACB(1) and (2).

FUNDS NOT ENGAGING A SPECIFIED PERSON

Qualifying fund

33. Section 20AC has been amended to provide for an additional avenue for bona fide private equity funds, which are not managed by persons licensed by or registered with the Securities and Future Commission, to be eligible for tax exemption. An offshore private equity fund carrying out a “specified transaction” would be eligible for tax exemption in respect of profits from that transaction if either of the following conditions is satisfied -

- (a) the specified transaction has been carried out through or arranged by a specified person;
- (b) the offshore private equity fund conducting the specified transaction is a “qualifying fund”.

34. In order to be a “qualifying fund” and hence be eligible for tax exemption, the following conditions must be met:

- (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 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.

35. Section 20AC(6) contains definitions of “aggregate capital commitment”, “associate”, “capital commitment”, “final closing of sale of

interests”, “investor”, “net proceeds” and “originator” in relation to the meaning of “qualifying fund”.

36. For the purposes of a qualifying fund, the “investor” is defined to mean a person, other than the originator or the originator’s associates, who makes capital commitment to the fund. The “originator” means a person who directly or indirectly originates or sponsors the fund; and has the power to make investment decisions on behalf of the fund. In the context of a limited partnership structure, generally the “investors” are the limited partners and the “originator” is the general partner.

37. The term of “capital commitment” means a commitment that is in the form of an amount of money payable by an investor, the originator or the originator’s associate to the fund under an agreement governing the operation of the fund; and in respect of which the originator may make capital calls from time to time according to the terms of the agreement. The “aggregate capital commitment” is the total of the capital commitments made by the investors, the originator and the originator’s associates.

38. In relation to a qualifying fund, “final closing of sale of interests” is defined to mean the date on which the originator last accepts subscriptions from investors for making capital commitments. The time of “final closing” should be clear from the fund document or prospectus which form part of a contract agreed at the outset. Since private equity funds are generally closed ended vehicles, the Commissioner would not accept that an originator can continually vary the closing date by inviting new subscribers into the fund, thereby moving the reference point of time.

39. Provisions on “associate” are required to prevent the private equity fund from being controlled by the originator and its associates. Section 20AC(6) contains the definition of “associate” and the related definitions of “associated corporation”, “associated partnership”, “control”, “principal officer” and “relative”.

Number of investors

40. There must be at least 5 investors, who have made capital commitment in the private equity fund, at any time after the final closing of

sale of interests. In a multi-layer ownership structure with a series of intermediaries or a fund of funds structure, it is essential to correctly identify the offshore private equity fund for the purposes of section 20AC before counting the number of investors.

Example 6

Limited Partnership F, being the main Fund, was a non-resident private equity fund with two parallel funds. The Fund Agreement of each parallel fund was substantially the same as the Fund Agreement for the main Fund, subject to modifications for regulatory, tax, structuring or other reasons. The size of the main Fund and the parallel funds were aggregated for purposes of any overall Fund size cap, and investors in the Fund and the parallel funds generally were aggregated for purposes of voting under the Fund Agreements.

The totality of facts, including the constitutive documents, the investment mandate and the management agreements, would be examined to decide whether the two parallel funds constitute two different persons for the purposes of sections 20AB and 20AC. If the two parallel funds constitute two different persons, each parallel fund will be counted as one investor. With the facts given in the example, the main Fund and the parallel funds should be looked upon as a single fund.

Example 7

Limited Partnership F1 was a private equity fund resident in Jurisdiction F1 with a master-feeder structure. In this case, the sponsor formed two feeder funds that would aggregate the commitments of certain investors from Jurisdiction F2 and Jurisdiction F3. One feeder fund was structured as a blocker vehicle and was taxed as a corporation for income tax purposes in Jurisdiction F2. This feeder fund would then invest directly in Limited Partnership F1 as a Limited Partner.

Feeder funds are often vehicles to account for the needs of the investors and they may not have independent existence on their own. To determine whether it is appropriate to see through the feeder vehicle when counting the number of investors, the totality of facts including the constitutive documents would be examined. Since the two feeder funds were set up purely to address the needs of investors from different jurisdictions for investment into Limited Partnership F1 only, it would not be inappropriate to see through the feeders when counting the number of investors.

Example 8

Limited Partnership F1 was a non-resident private equity fund, centrally managed and controlled in Jurisdiction F1. It was seeded by National Pension Plan F2 of Jurisdiction F2. National Pension Plan F2 funded retirement pensions, disability pension, death benefits, survivor's pension and other pension/benefit for some 18 million contributors and beneficiaries in Jurisdiction F2.

In general, a pension fund of such a scale is regulated by legislation and is likely to operate with great independence. The participants and beneficiaries of the pension fund would have no direct or indirect control or influence over the management of investments made by the pension fund. For the purposes of determining whether Limited Partnership F1 is a qualifying fund, National Pension Plan F2 would be counted as one investor.

Capital commitment

41. The 90% capital commitment condition in defining a qualifying fund means that the originator may make calls from time to time for payment of the capital, which has not been paid or satisfied by an investor, under a capital commitment according to the terms of agreement governing the operation of the fund. The aim is to ensure that the private equity fund is not simply a vehicle of one single investor. The term “capital calls” is not defined in the Ordinance. It carries the literal meaning (i.e. calls or requests for capital) and such calls are invariably governed by the contractual terms laid down in an agreement governing the operation of the fund.

Net proceeds

42. Section 20AC(6) defines the term “net proceeds” in relation to a fund at a particular time, to mean an amount calculated by:

- (a) adding together -
 - (i) the sum of the cumulative distributions received by the investors, the originator and the originator’s associates from the fund; and
 - (ii) the value at that time of all assets, if any, held by the fund; and
- (b) subtracting from the sum calculated under sub-paragraph (a) the cumulative capital contributions of the investors, the originator and the originator’s associates.

43. The 30% threshold of the net proceeds aims to deny tax exemption to funds the profits of which are simply siphoned to one single investor who may be the fund manager. The condition ensures that the vehicle is a bona fide private equity fund. That is, the private equity fund is not simply a vehicle majority owned by the fund manager with other investors holding nominal interest.

44. It is not uncommon in the private equity business to reward the fund manager a performance fee or carried interest which is around 20% of the fund’s profits above a hurdle rate. The 30% threshold is higher than the industry benchmark of 20%. In considering whether the 30% threshold has been observed, it is necessary to refer to various documents, such as the limited partnership agreement, so as to ascertain the performance fee, performance linked reward, carried interest or profit-related return (however described). It is also expected that fund constitutive documents, such as private placement memorandum and the management agreement, would be made available to the Assessor to prove that the fund is established as a bona fide private equity fund.

45. Distributions are always made by the fund manager after making provisions for all known liabilities as required by the distribution provisions in the agreement governing the operation of the fund. Therefore, it is expected that the distributions under paragraph 42(a)(i) above have been arrived in such manner.

SPECIAL PURPOSE VEHICLE

Exempt from tax payment

46. Section 20ACA(1) exempts an SPV, to the extent corresponding to the percentage of shares or interests held by the offshore private equity fund, which is exempt under section 20AC(1), from payment of tax in respect of assessable profits arising from the following transactions carried out for any year of assessment commencing on or after 1 April 2015:

- (a) transactions in shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, an interposed special purpose vehicle 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.

47. The SPV is a purpose-built structuring tool of private equity funds. It may be a corporation, partnership, trustee of a trust estate or any other entity which is incorporated, registered or appointed in or outside Hong Kong. It can be wholly or partially owned by a non-resident person and is established solely for the purpose of holding, directly or indirectly, and administering one or more excepted private companies. The term “any other entity” is included in the definition of SPV so as to facilitate the use of various forms of SPV, such as a contractual arrangement, by the industry.

48. The SPV is not allowed to carry on any trade or activities other than for the purpose of holding, directly or indirectly, and administering one or more excepted private companies. It should not engage in an active business with buying and selling transactions (i.e. trading transactions). Equally, it cannot derive service fees from the non-resident person (i.e. offshore private equity fund) for the provision of services. The SPV is expected to only derive passive dividend income from one or more excepted private companies.

49. Since the words “holding” and “administering” are not defined, they should be interpreted according to their literal meaning. That is, the SPV is to hold and administer excepted private companies in the capacity as a shareholder or a holder of participation or equity interest. The “holding” and “administering” of an excepted private company can be direct or through other persons. It should not be interpreted as the management of the business of the excepted private companies. That is, the maintenance and administration of the business of excepted private companies would not be allowed. Hence, the activities of the SPV are restricted to: the review of financial statements of excepted private companies normally made available to shareholders or investors; attending the shareholders’ meetings of excepted private companies; opening bank accounts for collection of dividends or investment receipts; and appointing company secretary and auditor.

50. The SPV in this context is not meant to be an excepted private company. In practice, the excepted private company can be identified after examining the transactions and having regard to the fund documents, including the investment mandate of the offshore private equity fund.

Interposed SPV

51. The term “interposed SPV” is defined to mean:

- (a) in relation to an SPV that has an indirect beneficial interest in an excepted private company through an interposed person that is an SPV, means the interposed person; or
- (b) in relation to an SPV that has an indirect beneficial interest in an excepted private company through a series of 2 or more interposed persons that are SPVs, means any of the interposed persons.

52. The definition of “interposed SPV” has made it clear that an interposed SPV is also an SPV, the “interposed SPV” will only be exempt to the extent corresponding to the percentage of shares or interests held by the non-resident person which is exempt under section 20AC(1). An SPV indirectly owned by a non-resident person is an “interposed SPV”.

Example 9

Limited Partnership F1 was a non-resident private equity fund. It held 100% of the share capital in Company F2 in Jurisdiction F2, through two wholly owned SPVs, Company SPV1 and Company SPV2, which were both Hong Kong incorporated companies without any trade or business activities in Hong Kong other than the holding of the share capital in Company F2. Company SPV1 held Company SPV2, which in turn held Company F2. Company F2 did not carry on any business or hold any immovable property in Hong Kong. Company F2 did not have interests in any other private companies.

Company SPV1 was an SPV and Company SPV2 was an interposed SPV. They both fell within the definition of SPV. They were used by Limited Partnership F1 to hold its equity investment in Company F2. Limited Partnership F1 would be exempt from tax under section 20AC(1) on profits derived from disposal of shares in Company SPV1 (i.e. an SPV). Company SPV1 would be exempt from payment of tax under section 20ACA(1) on profits derived from disposal of shares in Company SPV2 (i.e. an interposed SPV). Company SPV2 would be exempt from payment of tax under section 20ACA(1) on profits derived from disposal of shares in Company F2 (i.e. an excepted private company).

53. Depending on the market conditions, an offshore private equity fund may sell its investment in an excepted private company to another strategic investor or to the public through an initial public offering (IPO). If the private equity fund sells its investment in the excepted private company through an IPO, it is in substance no different from a transaction in listed securities or a transaction in securities of an excepted private company. That is, the offshore private equity fund will continue to be eligible for profits tax exemption in

respect of the divestment if the conditions in paragraph 16 above remain satisfied. Conversely, if a listed company after privatisation is sold as an excepted private company, the offshore private equity fund will continue to be exempt from profits tax provided the same conditions have been fulfilled.

54. Where an offshore private equity fund carries on any other business in Hong Kong other than the specified transactions and transactions incidental to the carrying out of specified transactions, it will lose its tax exemption status because of the provision in section 20AC(3). For example, an offshore private equity fund invests in a number of overseas private companies, one of which is carrying on business or holding an immovable property in Hong Kong (i.e. only one overseas private company fails to qualify as an excepted private company). Transacting in the securities of that overseas private company will taint the investments in other overseas private companies. Clearly, the offshore private equity fund is not eligible for profits tax exemption under section 20AC.

LOSS FROM EXEMPT TRANSACTIONS

Tax Treatment

55. Profits from specified transactions are exempt from tax. As a matter of symmetry, losses sustained by a tax-exempt offshore private equity fund from specified transactions in a year of assessment are not available for set off against any of its assessable profits for any subsequent year of assessment. Likewise, losses sustained by an SPV as defined by section 20ACA(2) from a transaction referred to in section 20ACA(1) in a year of assessment are not available for set off against any of its assessable profits for any subsequent year of assessment. The treatment is similar to that for offshore profits and capital gains. Since offshore profits or capital gains are not taxed, offshore or capital losses are not allowed to set off against the assessable profits of a person.

ANTI-ABUSE PROVISIONS

Resident person with 30% or more interest

56. Both section 20AE and 20AF are anti-abuse provisions to prevent abuse or round-tripping by resident persons, disguised as non-resident persons, to take advantage of the exemption. Section 20AF also prevents booking of profits in SPVs without distributing to the fund.

57. 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 under section 20AE 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. 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 20ACA(1)(a) to (c), the resident person is deemed under section 20AF to have derived assessable profits in respect of profits earned by the SPV.

58. The provisions in section 20AF apply from the year of assessment commencing on 1 April 2015.

Ascertainment of deemed profits

59. The amount of assessable profits deemed under section 20AE to have been derived by a resident person for a year of assessment is ascertained in accordance with Schedule 15 to the Ordinance. The amount of the assessable profits deemed under section 20AF to have been derived by a resident person for a year of assessment is ascertained in accordance with Schedule 15A.

60. Under section 20AE, the amount of deemed assessable profits will be the total sum by adding up the amount ascertained by the formula in paragraph 62 for each day in the period during which the resident person has the following percentage of direct and/or indirect beneficial interest in the tax-exempt offshore fund:

- (a) alone or jointly with his associates, 30% or more; or
- (b) any percentage if the offshore fund is the resident person's associate.

61. The amount of section 20AF deemed assessable profits will be the total sum by adding up the amount ascertained by the formula in paragraph 63 for each day in the period during which the resident person has the following percentage of direct and/or indirect beneficial interest in the tax-exempt SPV:

- (a) alone or jointly with his associates, 30% or more; or
- (b) any percentage if the offshore fund is the resident person's associate.

62. Part 1 of Schedule 15 sets out the following formula in ascertaining the amount of deemed assessable profits, out of the exempt profits of an offshore private equity fund, of the resident person for a particular day in a year of assessment:

$$A = \frac{B \times C}{D}$$

where : A means the exempt profits of the offshore fund for a particular day in a year of assessment

B means the extent of the resident person's beneficial interest in the offshore fund on the particular day

C means the exempt profits of the offshore fund for the accounting period in which the particular day falls

D means the total number of days in the accounting period of the offshore fund in which the particular day falls

63. Part 1 of Schedule 15A sets out the following formula in ascertaining the amount of exempt profits of an SPV, which amount is regarded as assessable profits of the resident person for a particular day in a year of assessment:

$$A = \frac{B1 \times B2 \times C}{D}$$

where : A means the exempt profits of the SPV for a particular day in a year of assessment

B1 means the extent of the resident person's beneficial interest in the non-resident person on the particular day

B2 means the extent of the non-resident person's beneficial interest in the SPV on the particular day

C means the exempt profits of the SPV for the accounting period of the SPV in which the particular day falls

D means the total number of days in the accounting period of the SPV in which the particular day falls

64. Part 2 of Schedule 15A to the Ordinance provides that the extent of the beneficial interest of the non-resident person (i.e. offshore private equity fund) in the SPV is:

- (a) if the SPV is a corporation that is not a trustee of a trust estate, the percentage of the issued share capital (however described) of the corporation held by the non-resident person;
- (b) if the SPV is a partnership that is not a trustee of a trust estate, the percentage of the profits of the partnership to which the non-resident person is entitled;
- (c) if the SPV is a trustee of a trust estate, the percentage in value of the trust estate in which the non-resident person is interested; or

- (d) if the SPV is an entity that does not fall within any of sub-paragraphs (a), (b) and (c) above, the percentage of ownership interests that the non-resident person has in the entity.

65. A non-resident person has an indirect beneficial interest in an SPV, if he has a direct beneficial interest in the first interposed person and the first interposed person has a direct beneficial interest in the next interposed person in the series and so on, and the last interposed person in the series has a direct beneficial interest in the SPV.

66. The extent of a non-resident person's indirect beneficial interest in an SPV is arrived at by multiplying the percentage of the non-resident person's beneficial interest in the first interposed person by the percentage of the first interposed person's beneficial interest in the next interposed person in the series and so on, and finally by the percentage of the last interposed person's beneficial interest in the SPV.

Example 10

On 1 October 2014, Company HK, a company resident in Hong Kong purchased 20% of the equity interest in Fund F1, which is a tax-exempt offshore fund. Fund F1 is not Company HK's associate. Company HK and its associates have no other beneficial interest in Fund F1.

Company SPV is an SPV wholly owned by Fund F1 used to hold Company F2 which is an excepted private company in Jurisdiction F2. On 1 January 2016, Company HK purchased a further 30% equity interest in Fund F1. Fund F1 closes its accounts on 31 March every year. During the year ended 31 March 2016, Fund F1 derived assessable profits of \$80m, excluding distribution from Company SPV, and Company SPV derived assessable profits of \$100m from disposal of shares in Company F2. Company SPV is exempt from payment of tax for the year of assessment 2015/16.

Deemed assessable profits of Company HK for the year of assessment 2015/16 is computed as follows:

$$\begin{aligned} & \$80\text{m} \times 50\% \times (91 \text{ days} \div 366 \text{ days}) + \$100\text{m} \times 50\% \times 100\% \\ & \times (91 \text{ days} \div 366 \text{ days}) = \$22.4\text{m} \end{aligned}$$

Number of days from 1 January 2016 to 31 March 2016 is 91. Days from 1 April 2015 (i.e. date of commencement of the 2015 Ordinance) to 31 December 2015 do not need to be taken into account since Company HK held a beneficial interest of 20% (i.e. less than 30%) in Fund F1 during this period.

Deeming provisions not applicable

67. Section 20AF(7) provides that the deeming provisions do not apply to a resident person if the Commissioner is satisfied that beneficial interests in the offshore fund concerned are bona fide widely held. This subsection is meant to be an escape route in case a resident person unintentionally holds a beneficial interest above the prescribed threshold in an offshore fund that is bona fide widely held by investors.

68. The term “bona fide widely held” has also been adopted in sections 20AE(8) and 26A(1A) of the Ordinance. In DIPN 20 (Revised) (Mutual Funds, Unit Trusts and Similar Investment Schemes) and DIPN 43, the expression “bona fide widely held” is consistently interpreted as follows:

- (a) during the year of assessment in question, at no time did fewer than 50 persons hold (or have the right to become the holders of) all of the units or shares in the scheme; and
- (b) at no time during the year did fewer than 21 persons hold (or have the right to become the holders of) units or shares that entitled the holders, directly or indirectly, to 75%, or more, of the income or property of the scheme.

69. Where the above benchmark figures are not met, the Commissioner will still accept in practice that the “bona fide widely held” requirement has been satisfied if it is clear from the constitutive documents of the fund and other relevant materials that it was established with a view to wide public

participation and that genuine efforts are being taken with the aim of achieving that objective. That is to say, there is nothing to suggest that the non-resident fund is intended to be a closely held investment vehicle. The “bona fide widely held” test applies to all offshore funds though private equity funds by their nature are unlikely to be widely held. Sovereign wealth funds, pension funds, central banks and government agencies are separate and independent legal entities with different investment mandates. Within a private equity fund, each of them is regarded as an investor. The fact that some investors are sovereign wealth funds, pension funds, central banks or government agencies cannot turn the private equity fund into a widely-held investment vehicle. However, sovereign wealth funds, pension funds, central banks and government agencies may enjoy tax exemption under sections 20AC or 26A(1A) subject to certain conditions in respect of their own profits.

70. To avoid double taxation, section 20AF(8) specifically provides that a resident person is not liable to tax in respect of the deemed assessable profits if any of the interposed resident persons through whom he holds an indirect beneficial interest in an SPV is liable to tax under the deeming provisions in respect of the assessable profits of the same SPV.

Example 11

Company HK1 held 90% of the share capital of Company HK2 which in turn held 70% of the share capital of Company HK3. Company HK3 held 50% of the equity interest in Fund F, a tax-exempt offshore private equity fund, which in turn held an excepted private company through Company SPV a wholly owned special purpose vehicle. Company HK1, Company HK2 and Company HK3 were all resident companies.

Per sections 20AE(1) and 20AF(1), deemed assessable profits representing 50% of the exempt profits of Fund F (if any) and 50% of the exempt profits of Company SPV (if any) would be attributed to Company HK3.

Since Company HK3 was subject to tax on the deemed assessable profits, Company HK1 and Company HK2 would be discharged from liability to tax per sections 20AE(9) and 20AF(8)

notwithstanding that they both held indirect beneficial interests of more than 30% (i.e. Company HK1: $90\% \times 70\% \times 50\% = 31.5\%$; Company HK2: $70\% \times 50\% = 35\%$) in Fund F.

Reporting requirements

71. Section 20AF imposes tax liabilities, which is similar to section 20AE, on a resident person in respect of the deemed assessable profits earned by an SPV. As with other persons chargeable to tax, the resident person bears the legal obligation of complying with the provisions of the Ordinance on reporting chargeability, lodgment of returns, providing information, payment of tax, etc. Penalties under Part 14 of the Ordinance may be imposed for failures to comply with the relevant statutory provisions. In determining the tax liability of the resident person, the Assessor may be required to examine the fund constitutive documents and accounting records of the tax-exempt offshore private equity fund.

TAXATION OF INVESTMENT MANAGER

Arm's length fee

72. While private equity funds falling within the offshore fund regime would not be subject to profits tax, Hong Kong based investment managers or advisors arranging or conducting the specified transactions are chargeable. These investment managers and advisors should be adequately compensated for their services or remunerated on an arm's length basis. Management and performance fees based on a cost-plus formula are not likely to have been determined on the arm's length basis, in particular when the investment managers or advisors performed significant functions and bore considerable risks in Hong Kong to generate the profits of the offshore funds.

Performance fees or carried interest

73. Many private equity funds are organized as limited partnerships. If the investments of the fund yield a positive return, both general and limited partners receive profits, as the value of their share of the fund increases. Compensation structures may vary from fund to fund, but the industry standard

pay formula is in general called “2 and 20”. That is, the investment managers take 2% of the fund’s asset each year as a management fee, and 20% of the profits above a hurdle rate as a kind of performance fee often described as “carried interest”.

74. Carried interest might be first received as income by the lead investment manager located outside Hong Kong or received as a distribution by the general partner and then allocated to the investment manager or advisor in Hong Kong. Where the investment manager or advisor in Hong Kong is not adequately remunerated for its service after considering the functions, assets and risks attributed to its Hong Kong operations, the arrangement will be closely examined. To counteract the tax benefit which would otherwise be obtained, the income accrued to the lead investment manager or distributions (unless comparable to the return arising on investments made by external investors in the fund) received by the general partner may be attributed under the general anti-avoidance provisions to the investment manager or advisor as profits derived from management or advisory services rendered in Hong Kong.

75. The place where Hong Kong investment managers or advisors rendered their services will further be examined before deciding the extent to which the management fees or carried interest attributable to the Hong Kong investment managers or advisors should be charged to profits tax. That is, whether the arm’s length management fees or carried interest should be wholly assessable.

76. Management fees and carried interest might also be structured as a distribution to fund executives of the investment manager or advisor through a general partner limited partnership or a carried interest limited partnership. Since the fund executives provide services in Hong Kong, either as an employee or in an independent capacity, distributions (unless comparable to the return arising on investments made by external investors in the fund) from the general partner limited partnership or the carried interest limited partnership would be chargeable, through the application of general anti-avoidance provisions, to salaries tax as employment income or profits tax as service income if the distributions are not genuine investment returns.

Example 12

Fund LP, an offshore private equity fund, was structured as a limited partnership. GP LP was the general partner of Fund LP and was itself a non-resident limited partnership. Carry LP, one of the limited partners of Fund LP, was itself a non-resident limited partnership. GP LP received from Fund LP a priority profit share which was the fee based on fund's assets under management at a rate of 2%. Carry LP received from Fund LP a carried interest at a rate of 20% of profits above a certain hurdle rate, packaged as an investment return. GP LP further allocated its profits to a general partner company which delegated, pursuant to a management agreement, the asset management function to a managing entity which provided the asset management function in Hong Kong. Individual fund executives, as well as being members and/or employees of the managing entity, were also limited partners in GP LP and Carry LP. Part of the priority profit share and carried interest were allocated directly to those individual fund executives from the GP LP and Carry LP.

The priority profit share received as professional income from the general partner company by the managing entity in Hong Kong would be assessed to profits tax as profits derived from services provided in Hong Kong. Individual fund executives could be taxed on their direct allocation of the priority profit share from GP LP and carried interest from Carry LP, either as service fee or employment income for providing services in Hong Kong, if the nature of the distribution differed from normal investment return received by external investors and the service fee or employment income allegedly received by the individual fund executives were not computed on an arm's length basis. The professional income of the managing entity could also be re-computed based on the arm's length principle so as to include priority profit share and carried interest booked in GP LP, Carry LP or the general partner company. Despite applying the anti-avoidance provisions to the remuneration arrangement of fund executives, the profits tax position of Fund LP would not be affected.

TAX AVOIDANCE

General anti-avoidance provisions

77. The Commissioner will generally act in accordance with this Note in providing profits tax exemption to offshore private equity funds and administering the related issues. However, where tax avoidance is involved, the Commissioner will consider invoking the general anti-avoidance provisions under sections 61 or 61A of the Ordinance as appropriate to counteract the tax benefits obtained.

78. If the fees received by investment managers, including carried interest, are disguised as investment returns, the general anti-avoidance provisions will be applied to counteract the tax benefits obtained and bring to charge the fees derived from the provision of management services in Hong Kong. The Commissioner however agrees that the anti-avoidance provisions will not be applied to arm's length return on genuine investment in the fund made. The investment return is an arm's length return if: the return is on an investment which is of the same kind as investments made by external investors; the return on the investment is reasonably comparable to the return to external investors on those investments; and the terms governing the return on the investment are reasonably comparable to the terms governing the return to external investors. The application of the anti-avoidance provisions however should not have any impact on the treatment of the offshore fund vehicle or investors.

TAX RESIDENCE

Tax residence of private equity funds

79. Most private equity funds are structured as limited partnerships. The private equity fund is regarded as a non-resident person if the central management and control of the limited partnership is exercised outside Hong Kong. The fact that the general partner resides in Hong Kong does not necessarily leads to the conclusion that the central management and control of the private equity fund is located in Hong Kong. Where the central management and control of a private equity fund is exercised by the general partner, the residence of the private equity fund is the place where the

management and control is exercised by the general partner. Though the central management and control may be exercised by the general partner in one jurisdiction, the actual business operations of a private equity fund may take place elsewhere.

Tax residence of SPV

80. Since the operation of an SPV is very restrictive by definition (i.e. holding and administering excepted private companies in the capacity of a shareholder), the place of residence of the SPV, wholly or partially owned by a non-resident private equity fund, generally follows that of the non-resident private equity fund despite that the SPV might be incorporated, registered or appointed in Hong Kong.

81. The certificate of resident status would only be issued to an SPV as a proof of its resident status for claiming tax benefits under the relevant Double Taxation Agreement (DTA) if it can be proved that the SPV is resident in Hong Kong. In deciding whether a certificate of resident status could be issued to an SPV all the facts and circumstances would be examined to determine whether the SPV has substantial business activities in Hong Kong (e.g. whether the SPV has a permanent office or employs staff in Hong Kong to hold and administer its investment in excepted private companies).

82. The issue of a certificate of resident status will be refused if the SPV is a mere conduit. In such a case, the SPV will not be regarded as a Hong Kong tax resident. The issue of a certificate of resident status to an SPV will not guarantee that it will be successful in its claim to treaty benefits. The decision as to whether relief from foreign taxes can be granted is, ultimately, one to be made by the DTA partner. It will be up to the DTA partner to determine whether all the relevant conditions are fulfilled and whether the benefits should be granted.

Typical Offshore Private Equity Fund Structure

