



Tax Newsflash

Hong Kong Tax News: FSDC recommends expansion of offshore PE fund profits tax exemption



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The Financial Services Development Council (FSDC), an advisory body to the Hong Kong Special Administrative Region government, released a report, entitled "[Proposals to Extend Offshore Private Equity Fund Tax Exemption to Hong Kong Businesses](#)" on 26 July 2017. The report sets out some key recommendations with a view to enhancing the existing tax exemption regime for offshore private equity (PE) funds and achieving more parity of treatment under the regime.

The offshore fund exemption regime, introduced in March 2006, grants a profits tax exemption from Hong Kong profits tax to qualifying nonresident funds on specified transactions. The exemption was expanded in 2015 (via the Inland Revenue (Amendment) (No. 2) Ordinance 2015) to apply to nonresident PE funds, with a view to encouraging PE firms to use Hong Kong as their asset management platform.

The FSDC report concludes that, despite the enactment of the legislation, there has not been a noticeable increase in the number of offshore PE funds managed in Hong Kong due to practical limitations of the current rules. To boost the development of the industry, the FSDC recommends that the profits tax exemption for offshore PE funds be extended to certain Hong Kong portfolio companies.

The FSDC identifies the two key limitations of the offshore PE fund tax exemption:

1. *Restriction on investment in Hong Kong private companies:* The offshore PE fund tax exemption does not apply to investments in Hong Kong private companies and non-Hong Kong private companies with substantial operations in Hong Kong, or that hold substantial Hong Kong real estate. Moreover, a single non-qualifying investment could taint the tax exempt status for the entire fund.
2. *Restriction on functionality of special purpose vehicles (SPVs):* The functions of an SPV are limited to holding and administering eligible offshore private companies or another SPV. However, SPVs cannot undertake any other management activities except for the purpose of holding and administering eligible offshore private companies.

The FSDC is of the view that for Hong Kong to reinforce its role as Asia's largest PE centre, the offshore PE fund tax exemption should be further enhanced such that it will have a wider applicability. In particular, the regime should not discourage investments in Hong Kong businesses and should put Hong Kong and non-Hong Kong investments on a level playing field for the offshore PE fund tax exemption.

The FSDC proposes the following adjustments to the legislation:

- Eliminate the "tainting" provision so that an offshore PE fund investing in a non-qualifying asset would be subject to tax only with respect to the investment income derived from the non-qualifying asset to the extent that income constitutes Hong Kong-source revenue gains;
- Extend the offshore PE fund tax exemption to cover investments in Hong Kong private companies and non-Hong Kong private companies with substantial operations in Hong Kong, with the exception of those holding substantial Hong Kong residential property;
- Introduce a provision to treat any gains derived from the disposal of a non-qualifying asset as capital in nature if such an asset has been held for more than two years; and
- Expand the scope of allowable activities of an SPV.

The FSDC report acknowledges that, in making any changes to the profits tax exemption regime, Hong Kong does not wish to be considered as a harmful tax jurisdiction, particularly in the context of the OECD BEPS project. The FSDC believes that its recommendations would help align the inherent inconsistencies in the current tax rules.

In light of the rapidly evolving international environment, the government should consider the recommendations from FSDC. Clarity, certainty and consistency in our offshore PE fund tax exemption rules are needed for Hong Kong to maintain its position as the leading international asset management centre in Asia.

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If you have any questions please contact:

Anthony Lau

Tax Partner

+852 2852 1082

antlau@deloitte.com.hk

Miranda Chan

Tax Manager

+852 2852 5626

mirchan@deloitte.com.hk



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