



Tax Newsflash

Hong Kong Tax News: Amendment to Offshore Funds Tax Exemption Regime in Hong Kong Gazetted

An amendment to Hong Kong's Inland Revenue Ordinance (IRO) contains measures aimed at encouraging offshore venture capital funds to participate in the Government's recently launched Innovation and Technology Venture Fund Scheme. The Inland Revenue Ordinance (Amendment of Schedule 16) Notice 2018, which was gazetted on 27 April 2018, would expand the types of transactions that qualify for a profits tax exemption and revise certain definitions under the existing offshore funds tax exemption regime (the Exemption Regime).

Under the Exemption Regime, nonresident funds can enjoy the profits tax exemption on "specified transactions" (as defined in Part 1 of Schedule 16 to the IRO) and transactions incidental to the carrying out of the specified transactions in Hong Kong. Transactions in shares of private operating companies incorporated in Hong Kong are not included on the list of specified transactions, and if a nonresident fund carries out any single transaction in Hong Kong that is not a specified transaction (or a transaction incidental thereto), the entire tax exemption status of the fund will be tainted.

In September 2017, the Government openly invited venture capital funds to participate in the Innovation and Technology Venture Fund Scheme, under which the Government would co-invest with venture capital funds in qualifying local innovation and technology start-ups (i.e. companies incorporated in Hong Kong subject to other criteria). Because transactions in private operating companies incorporated in Hong Kong would taint the profits tax exemption status of an otherwise qualifying offshore fund, offshore venture capital funds have expressed concerns that by co-investing with the Government in local

start-ups under the scheme, they could lose the profits tax exemption status under the Exemption Regime, meaning that all profits arising from their investment within and outside Hong Kong potentially could be taxable in Hong Kong. This, therefore, limits the participation of offshore venture capital funds in the Innovation and Technology Venture Fund Scheme.

The amendment to the IRO would add a new category of transactions to the list of specified transactions and revise relevant definitions. In particular, transactions in shares in an investee company under the Innovation and Technology Venture Fund Scheme would be added to the list of specified transactions, so that offshore funds would not be deprived of their otherwise available tax exemption status under the Exemption Regime because of their investment in local start-ups in Hong Kong under the scheme. However, an additional requirement (which applies only in relation to a transaction in the investee company under the scheme) would be introduced to qualify for the exemption, i.e. the offshore venture capital fund under the scheme would have to be a shareholder of the investee company under the scheme (i.e. the offshore venture capital fund directly invests in the investee company without using a special purpose vehicle). All other conditions under the Exemption Regime would continue to apply (e.g. the fund must be a non-resident person, the specified transactions must be carried out through or arranged by a "specified person" (or the fund is otherwise a "qualifying fund"), etc.).

The new rules will become effective on 22 June 2018, subject to the negative vetting by the Legislative Council.

The amendment to the IRO is welcomed because it should help address the tax concerns of offshore venture capital funds participating in the scheme, thereby encouraging private investment in local start-up businesses in the innovation and technology sector. However, it should be noted that the Financial Secretary announced in the 2018-19 Budget that the Government is embarking on a review of the existing tax concession arrangements applicable to the fund industry having regard to international requirements on tax cooperation. In light of this initiative, we would expect the Government to adopt a holistic approach to revisiting the Exemption Regime to identify any other potential areas that would benefit from a legislative change (e.g. removing the "tainting" features of the Exemption Regime, enhancing the applicability of the tax exemption to fixed-income/bond/credit funds, relaxing the benchmark figures for the "bona fide widely held" criteria specifically for private equity/venture capital funds, etc.).

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