Hong Kong enacts law to exempt private equity funds from Profits Tax

On 17 July 2015, the Hong Kong Inland Revenue (Amendment) Bill 2015 (the Bill), which sought to extend the current Profits Tax exemption for offshore funds to private equity funds (PE funds), was enacted (the new law). The new law will apply to relevant transactions occurring on or after 1 April 2015. The provisions of the new law are identical to those of the Bill (For more details, see EY Global Tax Alert, Hong Kong extends offshore fund exemption to private equity funds, dated 3 April 2015), which will generally enable a PE fund to invest in overseas private companies without exposing itself to tax in Hong Kong.

Under the new law, any gains generated by a special purpose vehicle company (SPV) from the disposal of a private company, referred to as an excepted private company (EPC), would be exempt from tax in Hong Kong at the SPV level. This allows PE funds to use a Hong Kong incorporated company as a vehicle for holding their offshore investment and would facilitate the development of Hong Kong as a holding company jurisdiction. It however remains to be seen whether an SPV, ultimately partially or wholly owned by a non-Hong Kong resident PE fund, formed solely for the purposes of holding and administering from Hong Kong an EPC, would create enough “substance” in order to claim treaty benefits. This may be of particular relevance given the increasing emphasis that some jurisdictions, including mainland China, are placing on substance, often taking into account factors such as the number and seniority of employees hired, the business operations conducted and the assets owned by an applicant when determining whether to grant treaty benefits.
Furthermore, as a result of the enactment of the new law, a PE fund may consider whether it would be desirable to change its previous operational protocol and relocate more of its functions or activities from overseas to Hong Kong. In such case, the PE fund also may need to review the transfer pricing arrangements between Hong Kong and the overseas jurisdictions involved.

In addition, PE funds need to be aware that certain provisions of the new law may require further clarifications by the Inland Revenue Department (IRD). The IRD has undertaken to make clarifications by issuance of a practice note shortly.

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