

HKMA issued Guidelines on Auditor's Reports for Application for Certification of Funds for tax concessions for carried interest

September 2022

On 31 August 2022, Hong Kong Monetary Authority (HKMA) issued the Guideline on Auditor's Report for Application for Certification of Funds Issued by the Monetary Authority for Funds and their Investment Managers (Guideline for Funds and their Investment Managers) and the Guideline on Auditor's Report for Application for Certification of Funds Issued by the Monetary Authority for Practising Members (Guideline for Auditors) (collectively, the Guidelines on Auditor's Report).

The Guidelines on Auditor's Report is an extension of the previous Guideline on Certification of Funds Issued by the Monetary Authority under Schedule 16D to the Inland Revenue Ordinance (Cap. 112) (Guideline on Certification) issued by HKMA on 16 July 2021 in relation to tax concessions for carried interest under the Inland Revenue Ordinance (IRO), which sets out the criteria for certification and other matters in relation to HKMA's certification of funds for the purposes of Schedule 16D to the IRO (Certification).

The Guideline for Auditors sets out the responsibilities of, and the procedures that should be carried out by, the auditor in preparing the auditor's report in support of a fund's application for Certification, whereas the Guideline for Funds and their Investment Managers sets out the responsibilities of, and the documents that to be provided by, the investment managers on the such matter.

Tax Concessions for Carried Interest

On 28 April 2021, the Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Bill 2021 passed its third reading in the Legislative Council.

The law provides that eligible carried interest received by, or accrued to, a qualifying person on or after 1 April 2020 from the provision of investment management services in Hong Kong to a qualifying payer, where the eligible carried interest arises from profits earned from in-scope transactions of the qualifying payer. If the substantial activities requirements are met, the amount of eligible carried interest would be eligible for a 0% profits tax rate. In the case of qualifying employees, 100% of employment income paid out of the eligible carried interest of the qualifying person to which profits tax exemption under the law applies can be excluded for ascertaining the salaries tax liabilities of the qualifying employees. According to the Schedule 16D of the law, the qualifying payer has to be a certified investment fund (Certified Investment Fund) certified by HKMA or an associated corporation, or an associated partnership, of the Certified Investment Fund that is a corporation or a partnership to be in compliance with the criteria for certification (Criteria for Certification) published by HKMA.

Detailed discussion of the Bill¹ is referred to our Hong Kong Tax alert - 28 January 2021 (2021 Issue No. 1)¹.

On 16 July 2021, HKMA further issued Guideline on Certification. Accordingly, HKMA will assess whether a fund has complied with the Criteria for Certification and certify if all the relevant criteria and requirements have been satisfied. The Inland Revenue Department (IRD) will then assess whether the fund as certified by HKMA satisfied all the applicable conditions under the law when claims for tax concessions for carried interest are made by the relevant qualifying persons and qualifying employees. Such guideline sets out the Criteria for Certification and how HKMA interprets the Criteria for Certification and other related matters.

¹ The tax alert can be downloaded from this link:
https://www.ey.com/en_cn/hong-kong-tax-alerts/legislative-bill-to-introduce-tax-concession-for-carried-interest

Or QR code:



According to the Guideline on Certification, a fund, as the applicant, has to submit to HKMA a completed "Certification Application Form" and the required supporting documents, including an auditor's report to apply for certification.

The auditor's report

According to the Guidelines on Auditor's Report, the fund or its investment manager is required to engage a certified public accountant (practising) of the Hong Kong Institute of Certified Public Accountants (HKICPA) to prepare the auditor's report in accordance with the Hong Kong Standard on Related Services 4400 (Revised) Agreed-Upon Procedures Engagements (HKSRS 4400 (Revised)).

As explained in HKSRS 4400 (Revised), in an agreed-upon procedures engagement, the auditor conducts the list of procedures as agreed upon with the engaging parties, where the engaging parties have acknowledged that the procedures performed are appropriate. The auditor communicates the agreed-upon procedures performed and the related findings in the report. The engaging parties and other intended users consider the agreed-upon procedures and findings reported by the auditor and draw their conclusions from work performed by the auditor.

An agreed-upon procedures engagement is not an audit, review or other assurance engagement. An agreed-upon procedures engagement does not involve obtaining evidence for the auditor expressing an opinion or an assurance conclusion in any form.

On the same date, 31 August 2022, HKICPA issued the Circular on Reporting for Certification of Funds under Schedule 16D to the Inland Revenue Ordinance (HKICPA Circular), providing the guidance to the practicing members when undertaking such engagements and illustrating the example agreed-upon procedures report under HKSRS 4400 (Revised).

According to the HKICPA Circular, the agreed-upon procedures report by the auditor is prepared based on the supporting documents provided by the investment manager. The specific procedures might vary from fund to fund. The investment manager is suggested to discuss and agree with the auditor, the relevant procedures to be performed as required by the Guidelines on Auditor's Report.

The agreed-upon procedures performed by the auditor would mainly cover ownership structures presented in diagrams (Ownership Structures Diagrams).

The following are the extracts from the Guidelines on Auditor's Report and the HKICPA Circular about the required information for the purpose of auditor's report:

Select any one acquisition of Specified Securities²

The investment managers select any one acquisition in any Specified Securities which has been disposed.

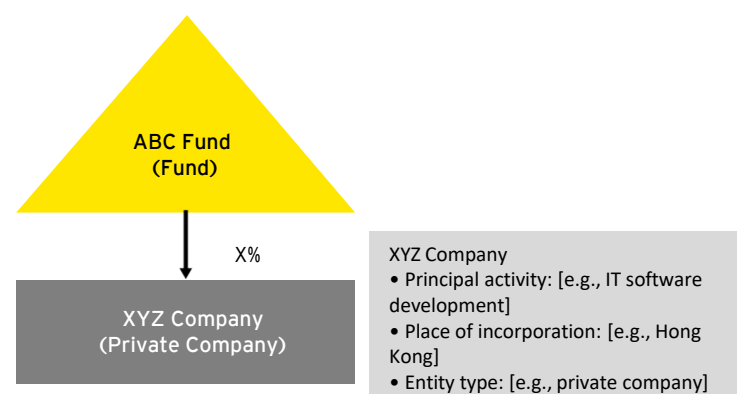
Documents to be provided in respect of certain key procedures for the purpose of agreed-upon procedures reports

- A. the executed sale and purchase agreement for the acquisition (Acquisition S&P);
- B. the Ownership Structures Diagrams (as illustrated at the right) showing
 - a) the description of the Specified Securities as stated in the executed Acquisition S&P, for example, 100% of the issued shares of an entity;
 - b) the acquisition date of the Specified Securities by the fund as stated in the executed Acquisition S&P;
 - c) the percentage of the fund's participation interests or equity interests, directly or indirectly, in the issuer of the Specified Securities, specifying the name and the identity of each entity (e.g., the fund, Special Purpose Entity (SPE), Interposed Special Purpose Entity 1/2/3 (Interposed SPE 1/2/3), Private Company or Investee Private Company (as the case may be)) as at the date of acquisition and the date of last disposal of the Specified Securities, or the date of declaration of the carried interest, whichever is earlier (Holding Period); and
 - d) the following information in respect of each entity in the Ownership Structures Diagrams:
 - principal activity;
 - place of incorporation; and
 - entity type, e.g., private company, public company, partnership
- C. the executed sale and purchase agreement for the disposal of the Specified Securities, or for the last disposal if there were more than one disposals (Disposal S&P); and
- D. the effective date of the executed Disposal S&P

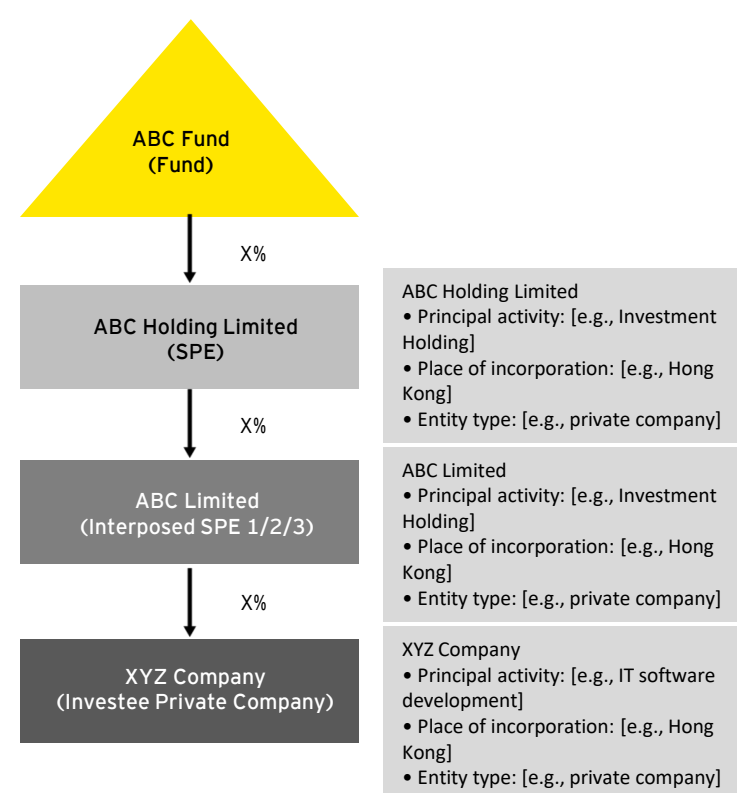
Where the issuer is a Private Company³

Description of the Specified Securities: [e.g., 100% of the issued shares of issuer]

Acquisition date of the Specified Securities: [e.g., 10 March 2020]



Where the issuer is an Investee Private Company⁴



² Specified Securities refer to shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a Private Company or an Investee Private Company (as the case may be) in which a fund has directly or indirectly invested in during the applicable period as required under paragraph 2.1(a) of the Guideline on Certification of Funds.

³ Private Company refers to the meaning as specified in Schedule 16C to Cap.112 Inland Revenue Ordinance (IRO).

⁴ Investee Private Company refers to the meaning for investee company as specified in Schedule 16C to Cap.112 Inland Revenue Ordinance (IRO).

E. For each of the SPEs, Interposed SPEs and issuer of the Specified Securities shown in the ownership structures in respect of the Specified Securities selected,

- a) a copy of the entity's audited financial statements for the year in which the carried interest was declared (Declaration Year);
 - (i) if the entity did not prepare the audited financial statements for the Declaration Year but has prepared the audited financial statements for the year preceding the Declaration Year, provide a copy of the audited financial statements for the year preceding the Declaration Year;
 - (ii) if the entity did not prepare the audited financial statements for the Declaration Year and the year preceding the Declaration Year or was exempted from audit pursuant to any overseas legislation, or if the principal activity of the entity was not stated in the audited financial statements provided to the Practitioner, or if the engaging party cannot obtain the audited financial statements prepared by the entity, provide a written representation stating the same, the overseas legislation concerned (if applicable), the reason for not being able to obtain the audited financial statements (if applicable), and the entity's principal activity for the Declaration Year.
- b) a copy of the entity's certificate of incorporation if the entity is a company;
 - (i) if the entity was incorporated in Hong Kong, provide a copy of the entity's Annual Return (Form NAR1) previously submitted to the Companies Registry which was made up during the Holding Period and indicated that the entity was a Private Company. Alternatively, provide a copy of the Notice of Change of Company Status (Form NAA4) previously submitted to the Companies Registry indicating that the effective date of alteration of the entity's company status fell within the Holding Period;
 - (ii) If the entity was not incorporated in Hong Kong, provide a written representation stating that the entity was not allowed to issue any invitation to the public to subscribe any of its shares or debentures at least one point in time during the Holding Period.
- c) Other documents and management representations upon requested by the auditor; and
- d) the auditor will carry out procedures agreed upon with the engaging parties according to HKMA guideline and use the evidence obtained as the basis for the auditor's report

Transitional arrangement

For eligible carried interest received or accrued from 1 April 2020 to 31 March 2022, the auditor's report must be submitted to HKMA within 180 calendar days from 31 August 2022 (the date of issuance of Guidelines on Auditor's Report) for HKMA to process the application.

Timeline for application for certification

The application for certification may be submitted after eligible carried interest has been received by, or accrued to, a qualifying person for a particular year of assessment. The application should be made on or before the applicable deadline which is determined based on the qualifying person's accounting year-end date as follows:

Accounting year-end date falling within:	Deadline:
1 April - 30 November	2 May in the following year
1 December - 31 December	15 August in the following year
1 January - 31 March	15 November in the same year

EY insights

The Guidelines on Auditor's Report and the HKICPA Circular issued on the same day and provided the clarity to specify what key work steps the auditor should conduct the agreed-upon procedures engagement, and lay out the suggested level of evidence to be obtained as the basis for the report of factual findings, in accordance with HKSRS 4400 (Revised). The Guidelines on Auditor's Report and the guidance provided by the HKICPA Circular are explicit and specific, particularly illustrating the example agreed-upon procedures report which enables the investment managers and the auditors to expedite the design and execution of the agreed-upon procedures, and conforms the work scope across different practising members when undertaking such engagements. As the auditor's report will form part of the completed Certification of Application Form, the Guidelines on Auditor's Report and the HKICPA Circular thereby facilitate the investment managers' application and certification process. We foresee, with the release of the abovementioned guidelines and circular, the tax concession regime for carried interest would draw considerable attention from global alternative fund managers to operate in Hong Kong. We are looking forward to supporting the alternative fund industry in the certification process.

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