

Hong Kong Tax Alert

28 January 2021
2021 Issue No. 1

Legislative bill to introduce tax concession for carried interest gazetted

The Inland Revenue (Amendment)(Tax Concessions for Carried Interest) Bill 2021 (the Bill) was published today¹. The long-awaited Bill seeks to promote the development of private equity (PE) funds in Hong Kong by ushering in a 0% profits tax rate on eligible carried interest and excluding 100% of eligible carried interest from employment income for ascertaining the salaries tax liabilities. In essence, eligible carried interest for qualifying persons and qualifying employees (collectively, qualifying recipients) would be treated as non-taxable. The eligibility criteria of the proposed tax concession are outlined and discussed in this alert.

Subject to the passage of the Bill by the Legislative Council, the concessionary tax treatment will be effective retrospectively and apply to eligible carried interest received by or accrued to any qualifying recipient on or after 1 April 2020.

Clients who wish to express their views on the provisions of the Bill can reach out to their tax executive so that we can relay the same message to the Hong Kong Government in an appropriate manner.

1. The Bill can be accessed via the following link:
https://www.legco.gov.hk/yr20-21/english/bills/brief/b202101291_brf.pdf

Background

Hong Kong is highly competitive vis-à-vis most other asset management centers across the world and ranked Asia's second in terms of total capital under management by PE funds after the Mainland China. In recent years, PE funds are gaining popularity amongst investors and are a key impetus to the growth of asset and wealth management business. The Hong Kong Government sees an opportunity to pursue more PE funds to operate in Hong Kong and elevate investment management and related activities to capture the latent business opportunities as well as economic benefits.

Taking into account the fact that tax treatment is a major consideration, among others, dominating the selection of jurisdiction for fund domiciliation and day-to-day management, the Hong Kong Government decides it is the high time to introduce the Bill to shape Hong Kong into a globally competitive premier PE fund hub.

An industry consultation has been conducted last year to gauge the industry's views. Contemplating all submissions received, the proposed parameters and eligibility criteria for the tax concession regime for carried interest are now set out in the Bill.

Tax concession for eligible carried interest

The Bill aims to bring about a 0% profits tax rate on eligible carried interest. On the other hand, the Bill excludes 100% of eligible carried interest from employment income for the purpose of salaries tax calculation.

Eligibility criteria

Eligible carried interest

Eligible carried interest refers to a sum received by, or accrued to, a person by way of profit-related return from the provision of investment management services by the person for a certified investment fund or the Innovation and Technology Venture Fund Corporation (specified entity).

The Bill proposes that a sum is a profit-related return if all of the following conditions are satisfied:

- ▶ The sum is received or accrued after the payment of a return on investments in the certified investment fund or specified entity subject to the fulfilment of the hurdle rate²;
- ▶ The sum arises only if there are profits for a period on the investments, or on particular investments, made for the certified investment fund or specified entity, or from a disposal of investment made for the fund or entity;
- ▶ The sum is variable by reference to those profits; and
- ▶ The returns to external investors of the fund or entity are determined by reference to those profits.

Qualifying carried interest payers

The Bill elucidates the definition of a qualifying payer as:

- 1) A certified investment fund, that is a fund which falls within the definition of "fund" under section 20AM of the Inland Revenue Ordinance (IRO) and certified by Hong Kong Monetary Authority (HKMA);
- 2) An associated corporation, or an associated partnership, of a certified investment fund³; or
- 3) The Innovation and Technology Venture Fund Corporation in Hong Kong (specified entity).

Qualifying carried interest recipients

The Bill sets out that the following qualifying person providing investment management service to a certified investment fund or specified entity in Hong Kong or arranging the relevant services to be carried out in Hong Kong is a qualifying recipient and should be eligible for the concessionary tax treatment:

- 1) a corporation or an authorized financial institution licensed/registered under Securities and Futures Ordinance to carry on regulated activity; or
- 2) a person, other than (1) above, carrying out investment management services in Hong Kong, or arranging such services to be carried out in Hong Kong, for a certified investment fund which is a "qualified investment fund" or a specified entity.

The Bill also sets out that qualifying recipient includes qualifying employee, who is an individual employed by a qualifying person (see above) or the associated corporation, or the associated partnership, of a qualifying person (provided that the associated corporation/partnership carries on a business in Hong Kong)⁴ and carries out the duties of the employment by providing investment management services in Hong Kong for, or on behalf of, the qualifying person.

Provision of investment management services

A non-exhaustive list of investment management services, in relation to a certified investment fund or specified entity, is set out in the Bill, as follows:

- 1) seeking funds from external investors or potential external investors;
- 2) researching and advising⁵ on potential investments;
- 3) acquiring, managing or disposing of property or investments; and
- 4) assisting investee companies to raise funds.

2. Hurdle rate means a preferred rate of return on investments in a certified investment fund or specified entity that is stipulated in the agreement governing the operation of the fund or entity.

3. This is to cater for the situation where eligible carried interest is distributed by a certified investment fund via a special purpose carry vehicle, such as a special limited partnership.

4. This is to cater for the situation where the individual is employed by a group company of the qualifying person (e.g., group employment entity), rather than directly by the qualifying person.

5. Compared to the consultation paper issued by the FSTB in August 2020, "advising on potential investment" is included in scope for investment management services to potentially cover non-investment professionals (such as legal, finance and middle office support) as they are involved in advising on PE transactions.

In-scope transactions

The Bill confines the coverage of in-scope transactions to those in relation to PE only. Thus, eligible carried interest must arise from profits on investments, on particular investments, or on a disposal of investment that are earned from a transaction:

- 1) in shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a private company specified in Schedule 16C to the IRO;
- 2) in shares of, or comparable interests in, a special purpose entity (SPE) or an interposed SPE that holds (whether directly or indirectly) and administers one or more investee private companies and no other assets of a class specified in Schedule 16C;
- 3) in shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, an investee private company;
- 4) incidental to the carrying out of the above qualifying transactions, subject to the 5% threshold in section 20AN of the IRO.

Subject to the fact and circumstance, certain hedging transactions forming part and parcel of the PE transaction and the relevant profits are embedded in the profit or loss on the PE transaction for the calculation of eligible carried interest may also qualify.

As a prerequisite to the concessionary tax regime, the profits arising from the above in-scope transactions of a certified investment fund or specified entity must be exempt from profits tax in accordance with sections 20AN or 20AO of the Unified Fund Exemption Regime (UFR) in the IRO.

Determining the amount of eligible carried interest qualifying for the tax concession

Where the qualifying person is subject to profits tax, the tax concession will apply to the net eligible carried interest after deducting the relevant outgoing and expenses and depreciation.

In the case of qualifying employee, the salaries tax concession will apply to employment income paid out of the eligible carried interest received by, or accrued to, a qualifying person and to which the profits tax concession applies.

Anti-avoidance provision

The Government envisages that some carried interest recipients may try to take advantage of the new tax concession under the Bill by disguising management fee or other remuneration received or receivable as eligible carried interest. Such profits derived by a qualifying recipient will be ineligible for the concessionary tax rate under the Bill.

In line with existing provisions under the IRO to combat tax avoidance, the Bill proposes that the eligibility of a qualifying recipient for the concessionary tax rate will be subject to a “main purpose test” provision.

Under the “main purpose test”, profits derived by a qualifying recipient would not able to enjoy the tax concession, if the main purpose, or one of the main purposes, of the person in entering into the arrangement is to obtain a tax benefit.

Substantial activities requirements

Consistent with other existing preferential tax regimes available in the IRO, the upcoming concessionary tax treatment on carried interest are subject to substantial activities requirements.

The Bill specifies for profits tax concessions to apply for the qualifying person, the qualifying person must have, in the opinion of the Commissioner of Inland Revenue (CIR), (i) an adequate number of full-time qualified employees and (ii) an adequate amount of operating expenditure incurred in Hong Kong in every relevant year of assessment (applicable period)⁶, including the following:

Substantial activities requirements	Thresholds
Average number of full-time qualified employees in Hong Kong	Not less than 2
Annual operating expenditure incurred in Hong Kong	Not less than HK\$2 million

6. Covering the period beginning on the day on which a person begins to carry out investment management services directly or indirectly for a certified investment fund or specified entity and ending on the day on which eligible carried interest is received by, or accrued to, the person.

The HKMA's certification and ongoing monitoring mechanism

To crack down on any tax abuse, the following concrete measures will be implemented:

Certification scheme

Funds will have to go through a certification process administered by the HKMA before applying the concessionary tax treatment to their eligible carried interest distributions. A letter of certification will be issued by the HKMA if it is satisfied that the relevant criteria are fulfilled.

External auditor's verification

As part of the certification scheme, an external auditor will need to be engaged in the year eligible carried interest distributions are made to verify the relevant substantial activities requirements are met in the relevant year(s) of assessment falling within the applicable period and that the distribution fulfils the specified conditions under the concessionary tax regime.

The auditor's report should be kept at the fund's local office or with the local authorized representative of a non-resident fund for inspection. The IRD may seek advice from the HKMA in assessing the taxpayer's eligibility to the tax concession.

Reporting obligations and proper record keeping

Qualifying recipients and qualifying payers should provide information to the CIR on the distribution of eligible carried interest and maintain sufficient records.

Effective date

The above proposed tax concession for carried interest, subject to the passage of the Bill, will take retrospective effect and apply to eligible carried interest received by or accrued to qualifying recipients on or after 1 April 2020, for any year of assessment on or after that date (i.e., year of assessment 2020/21).

Other amendments

Another amendment in the Bill relates to the alignment of the allowable investment scope at the fund level and the SPE level for the purposes of the UFR. The amendment allows SPEs to invest in the same asset classes as the investment fund itself (i.e., allow an SPE to hold and administer all of the asset types specified in Schedule 16C to the IRO). This will be a critically important change that should simplify the existing rules and provide much more certainty under the fund exemption rules.

Commentary

We welcome the introduction of the Bill which will boost the development of PE funds in Hong Kong.

Particularly, we have noted that certain changes have been made to the proposed tax concession regime after the industry consultation last year, such as:

- ▶ The coverage of qualifying payer has been broadened given different funds may adopt different carry structure (e.g., via special limited partnership or general partner) for the distribution of carried interest.
- ▶ The scope of investment management services is expanded to include those professionals who are involved in advising on PE transactions.
- ▶ Lowering the substantial activities requirement in terms of local operating expenditure from HK\$3 million to HK\$2 million to cater for start-up PE funds or venture capital funds.
- ▶ Allowing qualifying employees to be employed by a group company of the qualifying person.

Having said that, a key requirement of the proposed concessionary tax regime is it requires that the profits giving rise to the eligible carried interest must arise from PE transactions that are exempt from profits tax in accordance with section 20AN or 20AO of the IRO, i.e., the UFR. For funds which derive offshore sourced profits given the profit-generating activities are not carried out in Hong Kong or profits which are otherwise exempt under other provisions of the IRO, it is unclear whether the related carried interest can qualify for the tax concession.

Many of the provisions of the proposed regime are complicated; clients who wish to explore how they can benefit from the proposed tax concession for carried interest should contact their tax executives.

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