

HONG KONG PRIVATE EQUITY – GAME CHANGER?

On 7 August 2020 the Financial Services and the Treasury Bureau issued the consultation paper 'Proposal to Provide Tax Concession for Carried Interest'. The paper sets out the Government's proposal to introduce a concessionary tax rate for carried interest distributed by eligible private equity (**PE**) funds.

Government intends to introduce legislation as soon as practicable, with the concession to take retroactive effect from 1 April 2020.

This may be the missing piece to unlocking Hong Kong's potential to attract further PE funds and fund managers, following the new unified profits tax exemption for privately offered funds (effective from 1 April 2019) and the new limited partnership fund regime (effective from 31 August 2020). Particularly when set against the backdrop of the OECD-led economic substance requirements for traditionally popular offshore fund jurisdictions.

The price for this comprehensive suite of new PE incentive measures appears to be that the Securities and Futures Commission (**SFC**) will take a closer look at whether existing PE fund managers are appropriately licensed.

Overview of briefing

In this briefing we provide an overview of:

1. The favourable Hong Kong tax regime for PE funds / fund managers, including the new tax concession for carried interest
2. The new limited partnership fund (**LPF**) vehicle for PE funds
3. The SFC's recent change of approach to licensing PE fund managers
4. What to do next for PE firms who are interested in Hong Kong as a jurisdiction for funds and fund managers, or who already have a Hong Kong establishment.

1. Favourable Hong Kong tax regime for PE funds / fund managers

A. Generally favourable tax regime

Hong Kong has a generally favourable tax regime. Key features are:

- The tax system is territorial-based and does not tax profits derived from a source outside of Hong Kong
- Profits tax for companies and partnerships is currently 8.25% and 7.5% respectively for the first HK\$2 million (around US\$256,000), with profits above that threshold taxed at 16.5% and 15% respectively
- Salaries tax for employees is subject to a standard rate cap of 15% (or a progressive rate cap of 17%)
- No value added / goods and services tax
- No capital gains tax
- No inheritance tax.

B. New carried interest tax concession

A PE fund manager typically receives 'carried interest', being a return linked to the performance of a fund investment, when the investment is realised (typically by way of sale).

Carried interest, if derived from investment management services rendered in Hong Kong, is currently taxed as service income under profits tax or as employment income under salaries tax (as applicable).

The Government proposes that eligible carried interest (whether taxed under profits tax or salaries tax) will be taxed at a concessionary 'highly competitive rate', with retroactive effect from 1 April 2020. The rate has not yet been determined.

Further details of the carried interest proposals are set out in [Schedule 1](#).

C. New unified profits tax exemption for privately offered funds

As part of the Government's drive to attract further PE funds and fund managers to Hong Kong, a unified profits tax exemption for privately offered funds was introduced with effect from 1 April 2019, which applies equally to onshore and offshore funds and to investments in both local and overseas private companies, subject to meeting certain conditions.

Under the unified exemption, a privately offered PE fund is exempted from the payment of profits tax in respect of profits derived from eligible transactions in private companies, subject to meeting the exemption conditions.

Further details of the unified profits tax exemption are set out in [Schedule 2](#).

2. New LPF vehicle for PE funds

Hong Kong recently introduced a new LPF regime, effective from 31 August 2020, which is primarily aimed at attracting PE funds.

LPFs should be able to benefit from the new unified profits tax exemption.

Transfers of LPF interests will not be subject to Hong Kong stamp duty.

Further details of the new LPF regime are set out in our client bulletin available [here](#).

3. SFC change of approach to licensing PE fund managers

In our experience, the SFC is taking a closer look at PE fund managers to determine whether:

- unlicensed fund managers should be licensed (as licensed corporations); and
- licensed fund managers hold licences for the correct regulated activities.

SFC policy appears to have become stricter in treating non-Hong Kong private companies differently to Hong Kong private companies. This distinction is justified from a black-letter law interpretation of the term 'securities' in the Securities and Futures Ordinance (Cap. 571) because only Hong Kong incorporated private companies are excluded from that definition. In practice, however, many have taken the thrust of that exclusion and applied it to non-Hong Kong private companies as well.

The SFC's clarification of its policy here will have little effect on new PE fund manager entrants to Hong Kong as no doubt they will expect to be licensed by the SFC as the most obvious route to be eligible for the carried interest tax concession (see [Schedule 1](#) for further details).

Existing PE fund managers should revisit their licensing status (and, if licensed, whether they should apply for further regulated activities).

Further information on licensing of PE fund managers is contained in:

- the SFC 'Circular to private equity firms seeking to be licensed' dated 7 January 2020, which is available [here](#); and
- the SFC 'Licensing Handbook' (most recently updated in July 2020), which refers to private equity at paragraph 1.4.18. The Licensing Handbook is available [here](#).

4. What to do next for PE firms?

Against the backdrop of the OECD-led economic substance requirements for traditionally popular offshore fund jurisdictions, together with the raft of new PE-focused incentive measures introduced by the Hong Kong Government, PE firms should give serious thought to Hong Kong as a jurisdiction of domicile and operations both for funds and fund managers going forward.

Although the carried interest concessionary tax regime has not yet been tabled at the Legislative Council, PE firms who are interested in Hong Kong as a jurisdiction of domicile and operations for funds and fund managers should consider mapping out the relevant steps required now, noting that the time period for a PE fund manager to receive a licence from the SFC will likely require at least 20 weeks' engagement with the SFC as well as advance work to put together the application pack. Compliance advisers, tax advisers and legal counsel should be involved from the outset.

PE firms who already have a Hong Kong establishment should revisit their SFC licensing status, including the regulated activities permitted under any licence.

Please contact us if you would like to get ready for the new regime, including on how to progress fund formation, licensing and tax structure.

Schedule 1 - Tax Concession for Carried Interest

On 7 August 2020 the Financial Services and the Treasury Bureau issued the consultation paper 'Proposal to Provide Tax Concession for Carried Interest' (**Consultation Paper**). The Consultation Paper sets out the Government's proposal to introduce a concessionary tax rate for carried interest distributed by eligible PE funds.

The Government proposes that eligible carried interest (whether taxed under profits tax or salaries tax) will be taxed at a concessionary 'highly competitive rate', with retroactive effect from 1 April 2020. The rate has not yet been determined, but will take into account the latest developments in international tax standards.

The key features of the proposals set out in the Consultation Paper are summarised below.

1. Eligible funds

The tax concession will only apply to carried interest distributed by a fund which falls within the meaning of "fund" in section 20AM of the Inland Revenue Ordinance (Cap. 112) (**IRO**). The fund must be validated by HKMA and must appoint an authorised local representative, responsible for providing the necessary particulars and information to the Inland Revenue Department (**IRD**) and Hong Kong Monetary Authority (**HKMA**) on behalf of the fund.

2. Definition of "carried interest"

Following the UK approach, carried interest will mean a sum which is received or accrued to the persons concerned by way of "profit-related return", meaning that: (i) the carried interest must arise only if the validated fund is making profits; (ii) the carried interest paid would vary substantially by reference to the profits; and (iii) the return to external investors is also determined by reference to the same profits.

Separately from the above definition, carried interest will also include a sum paid out of the profits derived from the qualifying transactions of the validated funds, subject to the condition that the sum arises after all, or substantially all, of the fund's investments have been repaid to external investors; and each external investor has received a preferred return at an annual rate of 6% compound interest.

The concessionary tax treatment will be ring-fenced to carried interest distributed under PE transactions only. Specifically, the carried interest must arise from a tax-exempted qualifying transaction in the shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a private company under Schedule 16C IRO (which includes both Hong Kong and non-Hong Kong private companies).

3. Eligible carried interest recipients

The following persons providing investment management services (as defined in paragraph 4 below) to a validated fund in Hong Kong or arranging such services to be carried out in Hong Kong will be eligible for the concessionary tax treatment:

- (i) a corporation licensed by or an authorized financial institution registered with the SFC;
- (ii) any other person providing investment management services in Hong Kong to a validated fund which is a "qualified investment fund" as defined in section 20AN(6) IRO in Hong Kong or arranging such services to be carried out in Hong Kong; and
- (iii) any individual deriving assessable income from the employment with the qualifying persons referred to in subparagraph (i) or (ii) above by providing investment management services to the validated funds on behalf of the individual's employer.

4. Provision of investment management services

The carried interest must be derived from the provision of investment management services in Hong Kong to a fund validated by the HKMA.

The term "investment management services" will be defined to include:¹

¹ This follows a similar definition in the UK Income Tax Act 2007 and the definition of "services" in the repealed section 20AJ(3) IRO.

- (i) seeking funds for the purposes of the validated fund from participants or potential participants;
- (ii) researching potential investments to be made for the purposes of the validated fund;
- (iii) acquiring, managing or disposing of property for the purposes of the validated fund; and
- (iv) acting for the purposes of the validated fund with a view to assisting an entity in which the fund has made an investment to raise funds.

5. Deduction of expenses

Only the net carried interest after deducting any outgoing and expenses and depreciation will be eligible for the tax concession. Any loss sustained is not available for set off against any of the assessable profits for the year or any subsequent year of assessment.

6. Anti-avoidance provision

The concessionary tax treatment will not be available if the Commissioner of Inland Revenue is satisfied that the main purpose, or one of the main purposes, of a person entering into the arrangement is to obtain a tax benefit.

7. Substantial activities requirements

In order for carried interest to be eligible for concessionary tax treatment, carried interest recipients in paragraph 3(i) or 3(ii) above must have, in the opinion of the Commissioner of Inland Revenue, an adequate number of qualified full-time employees and operating expenditure incurred in Hong Kong for the year of assessment, including:

- (i) at least two investment professionals (or one investment professional and one related professional in legal, compliance or finance); and
- (ii) at least HK\$3 million in local expenditure incurred in Hong Kong.

8. HKMA validation and ongoing monitoring mechanism

HKMA validation

Funds intending to apply for validation under the proposed carried interest regime, or the local authorised representative of non-resident funds, should submit an application to HKMA. The application should comprise: (i) the fund's formation documents such as the private placement memorandum, structure chart, etc; (ii) the historical local expenditure and / or budget of the entire fund structure; (iii) the historical local hire and / or estimated hire of the investment manager; and (iv) a list of its local employees containing the information on position and function.

The information referred to in (i) above will enable the HKMA to assess whether the fund is a fund focusing on PE investment strategies. The information referred to in (ii), (iii) and (iv) above will enable the HKMA to assess whether the local employment and local spending requirements are likely to be met. The HKMA may also conduct visits to the fund's local office or ask for information on the fund's investment track record (if applicable) to assist its assessment.

Ongoing monitoring

In a particular tax year where there is carried interest distribution, the fund should engage an external auditor to certify that the relevant substantial activities requirements are met in the relevant tax year and that the carried interest distribution fulfils the conditions under the tax concession regime. The auditor's certification should be kept at the fund's local office or with the local authorised representative for inspection by HKMA from time to time, or by the IRD in regard to any matter which may affect any liability, responsibility or obligation of any person under the IRO.

Validated funds or the local authorised representative of non-resident validated funds will be required to report in writing all particulars of carried interest distributions (including the names, Business Registration numbers / Hong Kong Identity Card numbers and addresses of the carried interest recipients, and the amount distributed) to the Commissioner of Inland Revenue.

Schedule 2 - Unified Profits Tax Exemption

The Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Ordinance 2019 came into effect on 1 April 2019, unifying the profits tax exemptions for privately offered funds so that they apply (for transactions in specified assets and subject to meeting certain conditions) equally to onshore and offshore funds, irrespective of their structure, location of central management and control, size or the purpose they serve, and to investments in both local and overseas private companies.

1. Scope of the exemption

If an entity falls within the definition of 'fund' in the IRO, then its 'qualifying transactions' and transactions incidental thereto ('incidental transactions')², or in the case of a Hong Kong incorporated open-ended fund company (**OFC**) all of its transactions, will be exempt from profits tax, provided:

- (i) the fund is a 'qualified investment fund'; or
- (ii) the qualifying transactions are carried out in Hong Kong by a 'specified person' (being a corporation licensed by or an authorized financial institution registered with the SFC), or arranged in Hong Kong by a specified person.

The definition of 'fund' replicates (with necessary modifications) the definition of 'collective investment scheme' in the SFO.

A 'qualified investment fund' means a fund that falls in relation to which:

- (i) at all times after final closing: (a) the number of investors exceeds four; and (b) the capital commitments made by investors exceed 90% of the aggregate capital commitments; and
- (ii) the portion of the net proceeds of fund transactions to be received by the originator and its associates is limited to no more than 30%.

'Qualifying transactions' refer to transactions in assets of a class specified in Schedule 16C IRO.³ These include shares of both public and private companies, whether incorporated within or outside of Hong Kong. However, certain measures have been introduced to minimise the risk of tax evasion in relation to investments in private companies, as explained in paragraph 2 below.

A key feature of the new profits tax exemption is the removal of the tainting features of the previous regime, such that the tax-exempt profits of a fund are not tainted even if such fund is taxed on its non-qualifying transactions.

The new exemption is available not only at the fund level, but also to special purpose entities (**SPEs**) set up by the fund for the sole purpose of holding and administering investments in private investee companies, to such extent as corresponds to the percentage of shares or interests that the fund holds in the SPE.

² The exemption does not apply to assessable profits earned from incidental transactions if the fund's trading receipts from incidental transactions in a given tax year exceed 5% of the total of the fund's trading receipts from qualifying transactions and incidental transactions in such tax year.

³ The full list includes: (i) securities (as defined in the IRO); (ii) shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a private company; (iii) futures contracts; (iv) foreign exchange contracts under which the parties to the contracts agree to exchange different currencies on a particular date; (v) deposits other than those made by way of a money-lending business; (vi) deposits made with a bank (as defined by Part 1 of Schedule 1 to the SFO); (vii) certificates of deposit (as defined by Part 1 of Schedule 1 to the SFO); (viii) exchange-traded commodities; (ix) foreign currencies; (x) OTC derivative products (as defined by Part 1 of Schedule 1 to the SFO); and (xi) an investee company's shares co-invested by a partner fund and ITVFC under the ITVF Scheme.

2. Anti-avoidance provisions

As explained in paragraph 1 above, certain measures have been introduced to minimise the risk of tax evasion in relation to investments in private companies.

- (i) In respect of any private company in which a fund invests (other than a private company which directly or indirectly holds immovable property in Hong Kong, or share capital in another private company that directly or indirectly holds immovable property in Hong Kong), the profits tax exemption will not be available to the fund in respect of its investment in the company unless one of the tests below is satisfied:
- the fund holds its investment in the company for at least two years (the holding period test);
 - the fund does not have control over the company (the control test); or
 - the company holds (directly or indirectly) short-term assets the aggregate value of which does not exceed 50% of the value of the company's assets (the short-term assets test).
- (ii) In respect of any private company in which a fund invests which directly or indirectly holds immovable property in Hong Kong, or share capital in another private company that directly or indirectly holds immovable property in Hong Kong:
- if the aggregate value of such immovable property and share capital held by the private company exceeds 10% of the value of its assets, then the profits tax exemption is not available to the fund in respect of its investment in the company; and
 - if the aggregate value of such immovable property and share capital held by the private company is equal to or less than 10% of the value of its assets, then the profits tax exemption will not be available to the fund in respect of its investment in the company unless the holding period test, the control test or the short-term assets test is met.

In addition, the anti-round tripping provisions relating to the existing profits tax exemption for non-residents (which continues to apply to non-resident entities that do not fall within the new definition of 'fund' in the IRO) have also been duplicated with necessary modifications to prevent an investor resident in Hong Kong who either holds (either alone or jointly with any associates) a beneficial interest of 30% or more in an exempt fund or who is an associate of such exempt fund from using the new unified profits tax exemption to shelter otherwise taxable profits through the exempt fund⁴, unless the fund is bona fide widely held.⁵

⁴ This is achieved by deeming the assessable profits of the fund that would have been chargeable to profits tax but for the new unified profits tax exemption to be assessable profits of the resident investor to the extent of the investor's beneficial interest in the fund.

⁵ On the meaning of 'bona fide widely held', although the Inland Revenue Department exercises discretion the starting point is the test is satisfied where both of the following tests are satisfied in the relevant year of assessment: (a) at least 50 persons held units, shares or interests in the fund; and (b) at no time in that year did fewer than 21 persons hold units or shares that entitled the holders to 75% or more of the property or income of the fund. The Inland Revenue Department has issued a statement that private equity funds by their nature are unlikely to satisfy this test. See paragraph 172 of Departmental Interpretation and Practice Notes No. 61 (Profits Tax - Profits Tax Exemption for Funds).

Contacts



PETER LAKE
PARTNER
T: +852 2901 7235
E: peter.lake@slaughterandmay.com



CHRIS MCGAFFIN
PARTNER
T: +852 2901 7230
E: chris.mcgauffin@slaughterandmay.com



MIKE RINGER
COUNSEL
T: +852 2901 7351
E: mike.ringer@slaughterandmay.com

London
T +44 (0)20 7600 1200
F +44 (0)20 7090 5000

Brussels
T +32 (0)2 737 94 00
F +32 (0)2 737 94 01

Hong Kong
T +852 2521 0551
F +852 2845 2125

Beijing
T +86 10 5965 0600
F +86 10 5965 0650

Published to provide general information and not as legal advice. © Slaughter and May, 2020.
For further information, please speak to your usual Slaughter and May contact.

www.slaughterandmay.com