SLAUGHTER AND MAY/

CLIENT BRIEFING

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HONG KONG PRIVATE EQUITY: 0% TAX RATE FOR CARRIED INTEREST

Introduction

On 29 January 2021, the Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Bill 2021 (**Carried Interest Bill**) was gazetted. The purpose of the Carried Interest Bill is to implement the proposals set out in the discussion paper (**Discussion Paper**) published on 4 January 2021 by the Legislative Council Panel on Financial Affairs on the forthcoming tax concession for carried interest distributed by eligible private equity (**PE**) funds, which proposed a concessionary tax rate of 0%.

This is a key development in strengthening Hong Kong's position as a PE centre, making it comparable with offshore jurisdictions.

Subject to the successful passage of the Carried Interest Bill through the Legislative Council, the concessionary tax treatment will apply retroactively to eligible carried interest received by or accrued to qualifying recipients on or after 1 April 2020.

The proposals in the Discussion Paper build on and enhance the PE proposals set out in the Financial Services and the Treasury Bureau's consultation paper published on 7 August 2020 (**Consultation Paper**). Our client briefing on the Consultation Paper is available here.

The proposal for a 0% tax rate for eligible carried interest is the latest initiative in a drive by the government to consolidate Hong Kong's position as Asia's premier fund hub for PE, 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). More information on the unified profits tax exemption and the limited partnership fund regime is contained in our client briefing linked above.

Summary

Key features of the updated proposals set out in the Discussion Paper include (in summary):

1. 0% tax rate for eligible carried interest

2. Available to PE funds with an average of at least two employees in Hong Kong carrying out investment management services and at least HK$2 million of operating expenditure incurred in Hong Kong in each relevant year of assessment

3. Eligible funds need to apply to the Hong Kong Monetary Authority (**HKMA**) for certification – this is a one-off test, based on whether fund makes PE investments and is likely to meet the local employment and spending requirements referred to above

4. Qualifying transactions limited to shares, stocks, debentures, loan stocks, funds, bonds or notes of private companies, or shares or comparable interests of special purpose entities (**SPEs**) set up to hold such companies

5. Eligible recipients include: (i) corporations licensed by or financial institutions registered with the Securities and Futures Commission (**SFC**); (ii) other persons providing investment management services in Hong Kong to a certified "qualified investment fund" (i.e. a fund with at least 5 investors and meeting certain requirements as to capital commitments and distribution of net proceeds); and (iii) employees of the foregoing persons providing investment management services in Hong Kong on behalf of such persons.

Further details are set out below.

Detailed overview

1. What is eligible carried interest?

"Eligible carried interest" means a sum received by or accrued to a person by way of profit-related return subject to a 'hurdle rate', being a preferred rate of return on investments in the fund which is stipulated in the agreement governing the operation of the fund.

The term "profit-related return" encompasses three conditions:

a) the eligible carried interest must arise only if there are profits for a period on the investments, or on particular investments, made for the purposes of the certified investment fund (see paragraph 5 below), or there are profits arising from a disposal of investment of the fund;

b) the eligible carried interest paid would vary by reference to the profits; and

c) the returns to external investors are also determined by reference to the same profits.

The clarification in the Discussion Paper that the 'hurdle rate' is that stipulated in the agreement governing the operation of the fund is helpful, as it was unclear in the Consultation Paper whether the specified percentage referred to therein (6%) was fixed or was intended only as an example.

2. What is an eligible carried interest payer?

The tax concession will only apply to eligible carried interest distributed by a fund which falls within the meaning of "fund" under section 20AM of the Inland Revenue Ordinance (Cap. 112) (**IRO**). This is a broad definition which replicates (with necessary modifications) the definition of "collective investment scheme" in the Securities and Futures Ordinance (Cap. 571) (**SFO**).

The fund must also be certified by the HKMA (see paragraph 5 below). In the case of a non-resident fund, an authorised local representative must also be appointed, who will be responsible for providing the necessary particulars and information to the Inland Revenue Department (**IRD**) and the HKMA on behalf of the fund.

In addition, The Innovation and Technology Venture Fund Corporation (**ITVF Corporation**), established by the government under the under the Innovation and Technology Venture Fund Scheme, will be eligible for the tax concession.

3. What are qualifying transactions of a certified investment fund?

In line with the government's policy objective to promote the development of PE funds in Hong Kong, the concessionary tax treatment will be ring-fenced to eligible carried interest arising from qualifying transactions in PE only.

In the Consultation Paper, this was limited to carried interest arising 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 to the IRO.

Following consultation with the industry, this has been expanded in the Discussion Paper so as also to cover transactions in shares or comparable interests of an SPE or interposed SPE which is solely holding (whether directly or indirectly) and administering one or more investee private companies; or transactions in shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, an investee private company held by such an SPE or interposed SPE.

Transactions incidental to the above mentioned qualifying transactions will also qualify, provided that the trading receipts from incidental transactions do not exceed 5% of the total trading receipts from qualifying transactions and incidental transactions. If the 5% test is not met, then no incidental transactions will qualify for the relief (not just those above the 5% threshold). However, this does not affect the availability of the relief for the qualifying transactions to which the incidental transactions relate (subject to the other conditions for relief being met).

In order to prevent tax abuse, qualifying transactions also have to meet all the relevant tax exemption conditions under the profits tax regime for privately offered funds under sections 20AM to 20AY of the IRO. More information on these conditions is contained in our client briefing mentioned above (see link above).

4. Who are qualifying carried interest recipients?

As proposed in the Consultation Paper (now expanded also to cover the ITVF Corporation), qualifying recipients under the Discussion Paper include the following persons providing "investment management services" to a certified investment fund (or the ITVF Corporation) in Hong Kong, or arranging such services to be carried out in Hong Kong:

a) corporations licensed or authorised financial institutions registered under Part 5 of the SFO for carrying on a business in any regulated activity;

b) any person not falling within a) above providing investment management services in Hong Kong to a certified investment fund which is a "qualified investment fund"[1] (or the ITVF Corporation), or arranging such services to be carried out in Hong Kong; or

c) an individual deriving assessable income from the employment with the qualifying persons referred to in a) or b) above or their associated corporation or partnership by providing investment management services in Hong Kong to the certified investment funds (or the ITVF Corporation) on behalf of the qualifying persons.

As proposed in the Consultation Paper (now expanded also to cover the ITVF Corporation), "investment management services" include:

a) seeking funds for the purposes of the certified investment fund from external investors or potential external investors;

b) researching and advising on potential investments to be made for the purposes of the certified investment fund (or the ITVF Corporation);

c) acquiring, managing or disposing of property and investments for the purposes of the certified investment fund (or the ITVF Corporation); and

d) acting for the purposes of the certified investment fund (or the ITVF Corporation) with a view to assisting an entity in which the fund (or the ITVF Corporation) has made an investment to raise funds.

In addition, qualifying carried interest recipients 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 relevant years of assessment, including:

a) an average of two or more full-time employees in Hong Kong who carry out the investment management services; and

b) operating expenditure incurred in Hong Kong for the provision of the investment management services of at least HK$2 million or more.

This is a relaxation of the position in the Consultation Paper, which required not less than two investment professionals (or one investment professional and one related legal, compliance or finance professional) and not less than HK$3 million in local expenditure incurred in Hong Kong.

5. HKMA certification and on-going monitoring

As proposed in the Consultation Paper, funds are required to apply for certification from the HKMA before concessionary tax treatment will apply to their eligible carried interest distributions. The HKMA will assess, based on the information provided, whether the fund makes PE investments and whether the local employment and local spending requirements of the carried interest recipients are likely to be met. A letter of certification will be issued by the HKMA if it is satisfied that the relevant criteria are met.

In a particular year of assessment where there is a distribution of eligible carried interest, an external auditor should be engaged to verify that the relevant substantial activities requirements imposed on the carried interest recipients are met in the relevant year(s) of assessment, and that the distribution fulfils the conditions under the tax concession regime.

The IRD may seek advice from the HKMA in order to ascertain whether (amongst other things) an activity constitutes an investment management service, a sum may be eligible carried interest and/or an entity is a certified investment fund; and qualifying carried interest recipients and certified investment funds are required to provide information to the IRD in relation to the distribution of eligible carried interest and keep sufficient records.

6. Deduction of expenses and loss not available to set off

As proposed in the Consultation Paper, only the net carried interest after deducting any outgoings and expenses and depreciation will be eligible for the tax concession. In addition, any loss sustained will not be available for set off against any of the assessable profits for the year or any subsequent year of assessment.

[1] A "qualified investment fund" means a fund: (i) which at all times after final closing has at least five investors whose capital commitments exceed 90% of the aggregate capital commitments; and (ii) in relation to which 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%.

7. Anti-avoidance provisions

As proposed in the Consultation Paper, in order to prevent tax abuse, 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, the concessionary tax treatment will not apply to the person concerned.

The Discussion Paper also confirms that the government will specify in the legislation that management fees (even if disguised as eligible carried interest) received by qualifying carried interest recipients will not be eligible for the tax concession. This is expressly provided for in the Carried Interest Bill.

8. Enhancements to profits tax regime for privately offered funds

In addition to the tax concession for carried interest, the Discussion Paper confirms that the government proposes to make certain enhancements to the profits tax regime for privately offered funds in order to facilitate the operation of funds in Hong Kong. The Discussion Paper notes that at present it is common for funds to hold financial assets other than private companies using SPEs established by the fund. However, an SPE, as currently defined under the IRO, is only allowed to hold and administer investee private companies, but not other financial assets.

To address the PE industry's concern, the government proposes to: (i) allow an SPE to hold and administer assets of a class specified in Schedule 16C to the IRO; and (b) allow an SPE to carry out transactions in such assets on behalf of the fund. These proposals are reflected in the Carried Interest Bill. This is a welcome development which addresses an obvious shortcoming in the existing rules.

Concluding observations

With a concessionary tax rate of 0% for eligible carried interest, alongside the new unified profits tax exemption for privately offered funds and the new limited partnership fund vehicle, Hong Kong is now well positioned to fulfil the government's objective of consolidating Hong Kong's position as Asia's premier fund hub for PE.

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