

# 立法會 *Legislative Council*

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## **Bills Committee on Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Bill 2021**

### **Background brief**

#### **Purpose**

This paper provides background information on the Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Bill 2021 ("the Bill"). It also summarizes the views and concerns expressed by members when the Panel on Financial Affairs ("FA Panel") was consulted on the legislative proposals concerned.

#### **Background**

2. Private equity ("PE") fund is a collective investment scheme with its underlying assets primarily consisting of equity securities of private companies<sup>1</sup> that are not publicly traded on a stock exchange. PE funds (including venture capital funds) are gaining popularity amongst investors and have become a key impetus to the growth of asset and wealth management business in recent years. PE funds play a pivotal role in channelling capital, talents and expertise into corporations, in particular start-ups in the innovation and technology sector.

3. A service provider of a PE fund typically receives as remuneration an annual management fee,<sup>2</sup> and a return linked to the performance of an

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<sup>1</sup> There are different investment strategies for private equity ("PE") funds. PE funds typically invest in private companies and may exit through trade sale or initial public offering. Some PE funds would take private a listed company, increase the value of the company acquired through various strategies such as implementing a growth plan, restructuring the company, introducing new processes and technologies that will improve the operational efficiency and productivity of the company, and exit by going public in another stock exchange. Generally, the entire process takes several years.

<sup>2</sup> The annual management fee represents a specified percentage of the fund's assets under management under an investment management agreement.

investment ("carried interest").<sup>3</sup> Currently, any management fee and carried interest derived from investment management services rendered in Hong Kong are chargeable service income for profits tax or chargeable employment income for salaries tax (as the case may be).

4. Given that tax treatment is one of the key factors influencing the choice of jurisdiction for fund domiciliation and operation, the Financial Secretary announced in the 2020-2021 Budget Speech the policy initiative to provide tax concessions for carried interest issued by PE funds operating in Hong Kong subject to the fulfilment of certain conditions, with a view to attracting more PE funds to operate in Hong Kong, and boosting more investment management and related activities which will create business opportunities in related professional services and bring economic benefits to Hong Kong.

5. A task force, led by the Financial Services and the Treasury Bureau ("Task Force") and comprising members from the Inland Revenue Department, Hong Kong Monetary Authority and Securities and Futures Commission, has examined how tax concessions could be applied to carried interest distributed by PE funds. Moreover, a four-week industry consultation was conducted from August to September 2020. According to the Administration, the financial services industry generally welcomed the proposed tax concession regime for carried interest ("tax concession regime").

### **The Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Bill 2021**

6. The Bill was gazetted on 29 January 2021 and received its First Reading at the Legislative Council ("LegCo") meeting of 3 February 2021. The Bill seeks to amend the Inland Revenue Ordinance (Cap. 112) to:

- (a) give profits tax and salaries tax concessions to qualifying persons and qualifying employees in relation to particular types of carried interest received by, or accrued to, the qualifying persons and the qualifying employees from the provision of investment management services by those persons and employees for certain funds and entities;

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<sup>3</sup> This return is typically paid upon the disposal of the investment after it has been held for a period of time and subject to a hurdle rate, which means a preferred rate of return on investments in the fund which is stipulated in the agreement governing the operation of the fund.

- (b) expand for the purposes of profits tax exemption the eligible classes of assets that may be held and administered by a special purpose entity on behalf of a fund that owns the entity; and
- (c) provide for related and transitional matters.

7. Details of the major provisions of the Bill are set out in paragraph 23 of the LegCo Brief (File Ref: ASST/3/1/8/1C dated 27 January 2021), and paragraphs 5 to 17 of the Legal Service Division Report on the Bill (LC Paper No. LS34/20-21).

8. The Bill will apply concessionary tax treatment to eligible carried interest received by or accrued to qualifying carried interest recipients on or after 1 April 2020. The Bill, if passed, would come into operation on the day on which the enacted Ordinance is published in the Gazette.

### **Major views and concerns expressed by Members**

9. The Administration briefed the FA Panel on the legislative proposals to provide tax concessions for carried interest distributed by eligible PE funds operating in Hong Kong at the meeting on 4 January 2021. The major views and concerns expressed by members at the meeting are summarized in the ensuing paragraphs.

#### *Development of the private equity fund industry in Hong Kong*

10. Members enquired whether reference had been made to the relevant regimes of other jurisdictions, such as the Mainland and Singapore, in developing the proposed tax concession regime, and whether the Task Force had studied other measures to develop Hong Kong as a premier PE fund hub. Moreover, members asked about the rationale for proposing the concessionary tax treatment to take retrospective effect to apply to eligible carried interest received by or accrued to qualifying carried interest recipients on or after 1 April 2020.

11. The Administration advised that the Task Force would continue to review various measures to promote the development of PE fund industry in Hong Kong. For instance, the Administration was formulating legislative proposals to allow foreign funds to re-domicile to Hong Kong as Limited Partnership Funds ("LPFs") or Open-ended Fund Companies. As the growth of Hong Kong's PE fund industry was relatively slower than competitors including Singapore, it was necessary for Hong Kong to step up effort in enhancing its competitive edge on this front. Regarding the application of the proposed tax

concession regime, the Administration explained that the proposed regime was announced in the 2020-2021 Budget Speech, and stressed the need of taking swift action to expedite the development of PE fund industry in Hong Kong. Applying concessionary tax treatment retrospectively would provide certainty and facilitate the early decision of PE funds to domicile and operate in Hong Kong.

12. The Administration added that the PE fund industry in general considered various factors when choosing the location to set up and operate a fund, including investment opportunities, location of investors, supply of talents as well as professional services support. While Hong Kong had been all along very competitive in these aspects, there were two areas of concern, i.e. the lack of a modern legal framework for the establishment of LPFs and a competitive tax regime for carried interest distributed by PE funds. The Administration had introduced the Limited Partnership Fund Bill in 2020 (which was enacted as the Limited Partnership Fund Ordinance (Cap. 637) in August 2020) to enable the establishment of an investment fund in Hong Kong in the form of a limited partnership. The proposed tax concession regime was another measure to attract PE funds to operate in Hong Kong.

13. Some members enquired whether the Administration had studied the demand for PE funds in the Hong Kong capital chain, and developed measures to promote the development of PE fund sector in Hong Kong.

14. The Administration advised that the demand side of Hong Kong's capital chain included demand for investment opportunities and demand for financing opportunities. In respect of increasing the demand of investment opportunities, the Administration would introduce measures including promoting the development of family office business in order to increase the demand for PE investments. On the other hand, the Administration would develop Hong Kong as an innovation hub and promote the development of financial technologies so that companies in the relevant sectors would create financing opportunities for PE funds.

#### *Benefits of the proposed tax concession regime for carried interest*

15. Members sought information on (a) the estimated revenue forgone arising from the proposed tax concession regime; and (b) how the proposed tax concession regime could benefit Hong Kong, including quantitative benefits on new investment opportunities, the estimated number of jobs to be created, the estimated amount of capital under management by PE funds in Hong Kong after implementing the regime, and how the regime would promote Hong Kong's economic development as well as enhance its status as an international financial centre.

16. The Administration responded that the amount of capital under management by PE funds in Hong Kong was around US\$ 170 billion in the third quarter of 2020, and it would be difficult to quantify the benefits of the proposed tax concession regime on Hong Kong. Hong Kong had already lagged behind its competitors including Singapore in the development of PE fund industry. In particular, Hong Kong's competitors were offering competitive tax rates on carried interest distributed by PE funds, thus there was a pressing need to introduce the proposed tax concession regime to sharpen Hong Kong's competitive edge on this front. There were some 560 PE firms in Hong Kong in 2019. It was envisaged that the number would likely increase upon implementation of the proposed tax concession regime. As additional management fees paid to fund managers would be taxed in Hong Kong, additional tax revenue would be generated. Moreover, PE funds had many spill-over effects like strengthening Hong Kong's role as an international financial and innovation centre. The development of PE fund industry would not only enhance the ecosystem and value chain of Hong Kong's financial services sector but also increase the demand for various professional services including legal and accounting services. A study conducted by the Financial Services Development Council had estimated that one PE fund job could create up to three to six new jobs in related services industries, such as accounting, legal and financial services.

17. As regards the estimated revenue forgone, the Administration explained that the complexities involved in the assessment of carried interest of PE funds made it difficult to work out the estimated amount of revenue forgone arising from the proposed tax concession regime. Such complexities included the industry practice for a PE fund to hold its investment for a few years, and that carried interest would only arise if there were profits when the investment was disposed of with such profits meeting certain hurdle rate.

*Implementation details of the proposed tax concession regime for carried interest*

18. Given that some PE funds might allocate their capital in various jurisdictions, some members enquired whether there would be requirement for PE funds to allocate most of their capital in Hong Kong in order to be eligible for the proposed tax concession regime.

19. The Administration responded that it would not restrict the allocation of capital as free capital flow was one of Hong Kong's existing strengths and an important feature of an international financial centre. Besides, PE funds in general would not concentrate their capital in a single jurisdiction as they looked for suitable investment opportunities around the world. The

Administration would thus focus on attracting PE funds to conduct business activities in Hong Kong and the Guangdong-Hong Kong-Macao Greater Bay Area.

20. Some members suggested that the proposed tax concession regime should be extended to cover local securities firms licensed to carry out Type 9 regulated activities (i.e. asset management) so that a level playing field would be provided between the local brokerage firms and the PE fund sector.

21. The Administration explained that the proposed tax concession regime was confined to PE funds as the business nature of PE funds was different from that of local securities firms. For instance, PE funds faced greater risks as they usually invested in budding private companies and start-ups.

### **Latest development**

22. At the House Committee meeting on 19 February 2021, Members agreed to form a Bills Committee to study the Bill.

### **Relevant papers**

23. A list of relevant papers is in **Appendix**.

Council Business Division 1  
Legislative Council Secretariat  
8 March 2021

## List of relevant papers

Date	Event	Paper
4 January 2021	Meeting of the FA Panel	<a href="#">Administration's paper</a> (LC Paper No. CB(1)417/20-21(05))  <a href="#">Supplementary information provided by the Administration</a> (LC Paper No. CB(1)538/20-21(02))
3 February 2021	The Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Bill 2021	<a href="#">The Bill</a>  <a href="#">Legislative Council Brief</a> (File Ref: ASST/3/1/8/1C)  <a href="#">Legal Service Division Report</a> (LC Paper No. LS34/20-21)