香 港 稅 務 學 會
THE TAXATION INSTITUTE OF HONG KONG

CTA
特 許 稅 務 師
Chartered Tax Adviser

BY EMAIL and BY HAND

PRIVATE AND CONFIDENTIAL

Clerk to Bills Committee on Inland Revenue (Amendment)
(Tax Concessions for Carried Interest) Bill 2021
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong

Email: bc_04_20@legco.gov.hk

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Dear Sir,

Inland Revenue (Amendment)(Tax Concessions for Carried Interest) Bill 2021 (the Bill)

In response to the Bills Committee's invitation to the public to make submission on the Bill, we would like to provide below our views thereof.

A welcome move

Overall, we welcome the introduction of the Bill which, when enacted, should help develop Hong Kong as a regional hub for wealth and asset management, the promotion of the private equity (PE) fund industry in particular.

Over the past few years, the Government has spared no efforts in developing Hong Kong as a premier PE fund hub, including the introduction of a new limited partnership law effective from 31 August 2020 that specifically caters to the operational needs of PE funds.

We believe that the tax concessions to be granted under the Bill for eligible carried interest received by PE fund managers and their employees would further incentivize them to choose Hong Kong as the location of domicile and operations of funds under their management. Such fund management operations in Hong Kong will also create business opportunities in related professional services such as legal and accounting and bring economic benefits to Hong Kong.

This would particularly be the case given that Hong Kong will be a pioneer ahead of many competitors including Singapore to effectively grant total tax exemption for eligible carried interest received by PE fund managers and their employees.

We also appreciate the Government taking this opportunity to respond to the request of the industry to expand the investment scope of a special purpose entity (SPE) that is wholly or partly owned by a fund.

At present, where a fund employs an SPE to hold directly or indirectly its investment in private companies, the sole activities of said SPE will be limited to administering and holding the investee private companies. Otherwise, the fund's or the SPE's direct or indirect disposal of the investee private companies would not be exempt from tax in Hong Kong.

Under the Bill, a fund will in future be allowed to employ an SPE to hold its investments, not only in private companies, but also other common types of investment such as listed securities and derivative contracts that belong to any other classes of assets as specified in Schedule 16C to the Inland Revenue Ordinance (IRO).

We support this move which will give flexibility to the operational needs of funds, thereby providing more certainty to the operation of the unified fund exemption regime (UFE) under sections 20AM to 20AY of the IRO.

Comments on certain specific provisions of the Bill

Not denying the tax concessions for carried interest paid out of profits from an investment not qualifying for the profits tax exemption under the UFE (i.e. non-qualifying investment).

Under the Bill, it appears that eligible carried interest must be paid out by a fund from its tax-exempt profits under the UFE derived from transactions in the securities of a private company.

However, whether a fund's investment in a private company would be tax exempt under the UFE would depend on many factors, including (i) whether the private company concerned owns directly or indirectly less than 10% of its total assets in real estate in Hong Kong; or (ii) whether the short-term assets owned by the private company concerned over a period of three years before the fund disposes of the private company comprised less than 50% of the total assets of the private company.

Where either one of these conditions is not satisfied, the profits made by the fund from the disposal of the private company concerned would not be tax exempt under the UFE. In other words, the fund would be chargeable to tax in respect of such "bad" investment, but "bad" only in terms of falling outside the exemption scope of the UFE. However, the economic return of such investment could exceed the hurdle rate and therefore carried interest could be payable by the fund to its PE fund manager out of the profits made from such "bad" investment.

In such a case, given that the profits of the fund out of which the carried interest was paid would not be tax exempt under the UFE, the carried interest received by the PE fund manager would not be eligible for the tax concessions to be granted under the Bill. In turn, any carried interest on-paid by the PE fund manager to their employees would likewise not be eligible for the tax concessions.

We consider that there may be a case not to deny the PE fund manager and their employees the tax concessions in respect of carried interest received by them in such circumstances. This would be the case given that:

(i) a fund and its fund managers may not have control over the operations of an investee private company and therefore cannot always ensure that profits from such investment would be tax exempt under the UFE;

(ii) the policy objective of the Bill is to encourage more fund managers to choose Hong Kong as the location of domicile and operations of funds under their management; and

(iii) the policy consideration for denying a fund the tax exemption under the UFE for such "bad" investment may not apply to the policy consideration referred to in (ii) above.

Clarifying that investment management services need not be wholly performed in Hong Kong

Sections 4(3) and 5(2) of the new Schedule D under the Bill stipulate that the investment management services rendered by a PE fund manager must be carried out in Hong Kong or arranged to be carried out in Hong Kong if carried interest received from providing such services is to be eligible for the tax concessions to be granted under the Bill.

However, the nature of the PE fund industry is that many such investment management services would be performed or arranged to be performed by a PE fund manager outside Hong Kong given that many investee private companies may be located outside Hong Kong. As such, the Government may consider clarifying the issue by way of either (i) fine-turning the legislative wording of the Bill; or (ii) the Inland Revenue Department (IRD) issuing a practice note indicating that such investment management services need not be wholly carried out or arranged to be carried out in Hong Kong.

Carried interest received by overseas employees seconded to Hong Kong or by a director

The definition of "qualifying employee" in section 8(4) of the new Schedule 16D requires an individual to be employed by (1) a qualifying person or (2) an associated corporation or associated partnership of the qualifying person **provided that the associated entity carries on a business in Hong Kong**. International fund houses may second individuals who are employees of an associated overseas group entity to their PE fund management company in Hong Kong. During such secondment, these overseas staff may work under the direction and for the benefit of the Hong Kong fund management company and their employment costs could be borne locally. In other words, the Hong Kong fund management company could become their economic employer, while the associated overseas non-Hong Kong resident company remains their legal employer. We would like to seek clarification on whether the secondees under such arrangement will be regarded as a "qualifying employee" as defined.

In addition, section 8 of the new Schedule 16D appears to envisage that only Hong Kong employment (under which the whole amount of employment income is chargeable to tax under section 8(1) of the IRO) would be involved. However, there may be cases where an individual is having a non-Hong Kong employment with an associated overseas entity of a qualifying person and may be entitled to a time-apportionment claim during the secondment period in respect of their employment income derived from services rendered outside Hong Kong.

We consider that where such overseas staff receive carried interest from the Hong Kong fund management company during their secondment period, they should also be eligible for the tax concessions to be granted under the Bill.

Therefore, for that purpose, the definition of "qualifying employee" under section 8(4) of the new Schedule 16D may need to be amended to the effect that such overseas staff during the secondment period would be treated as being employed by the Hong Kong fund management company.

Furthermore, to cater for the situation where part of the income accrued from a non-Hong Kong employment of an individual is not "assessable income" subject to Hong Kong salaries tax, the definition of "B" for the formula stated in section 8(3) of the new Schedule 16D may need to be amended as meaning "the income accrued from the employment that is chargeable to tax in Hong Kong under section 8 of the IRO for the year of assessment".

Another issue is whether a statutory director without a separate written employment contract could be regarded as an employee of a qualifying person (i.e. a fund manager) under the Bill when said director receives carried interest in return for their provision of the investment management services for, or on behalf of, the qualifying person for a certified investment fund. The Government

may therefore also consider explicitly addressing the issue by way of (i) fine turning the legislative wording of the Bill; or (ii) the IRD issuing a practice note to explain and cover the situation.

Carried interest received by a special vehicle employed a PE fund manager

Given that the operations of a PE fund manager group may be spread across many group companies located in different jurisdictions, it is common for such a PE fund manager group to employ a special vehicle to receive carried interest. The special vehicle would then on-pay the carried interest to the group PE fund managers located in different jurisdictions including Hong Kong.

We understand that the definition of "qualifying payer" as contained in section 2 of the new Schedule 16D to include "an associated corporation, or an associated partnership of a certified investment fund that is a corporation or a partnership…" is to cover the situation where carried interest may be paid out from such a special vehicle to qualifying persons, in which case the qualifying persons may enjoy the tax concession for the carried interest received.

However, as for the Hong Kong profits tax exposure for such a special vehicle in respect of the carried interest received by it, it is not entirely clear from the Bill that such a special vehicle is to be treated as a tax transparent entity, attracting no tax liabilities in Hong Kong for its receipt of the carried interest. Since such special vehicle is usually a passive entity set up solely for the purpose of receiving carried interest, it would not qualify as a "qualifying person" as defined and cannot enjoy the tax concession for the carried interest received if it is not treated as a tax transparent entity. As such, the Government may consider clarifying the issue during this legislative process.

Filing of profits and salaries tax returns pending enactment of the Bill with retrospective effect from 1 April 2020

Upon enactment of the Bill, the tax concession may be applicable to the 2020/21 profits and salaries tax returns. The 2020/21 profits tax returns for N-code taxpayers will be due for filing in early May this year. The Bill however may not be passed into law before May and in any case, time would be required before a fund can be certified by the Hong Kong Monetary Authority as "a certified investment fund", a pre-requisite condition before the tax concession can be granted. In the meantime, we suggest the IRD providing guidelines or a mechanism under which tax concession under the Bill is to be claimed by taxpayers in their 2020/21 tax returns.

We trust the above would help the Bills Committee to scrutinize and deliberate on the Bill. Should you wish us to elaborate or clarify any of the above, please contact us.

Your sincerely,

For and on behalf of
The Taxation Institute of Hong Kong

Webster Ng
President

21/F., Kam Sang Building, 255-257 Des Voeux Road Central, Hong Kong
Tel: (852) 2810 0438 Fax: (852) 2523 1263 Web Site: www.tihk.org.hk E-Mail: tihkadm@tihk.org.hk