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23 March 2021

Clerk to the 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

Our Ref: ALA/CKP/MWY

Dear Sir,

Re: Response to Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Bill 2021 (the Bill)

We are pleased to submit comments on behalf of Deloitte Advisory (Hong Kong) Limited in response to the above Bill, which proposes that, subject to conditions, eligible carried interest will be subject to a 0% profits tax rate and fully excluded from employment income for the purposes of salaries tax.

First of all, we welcome the Government's introduction of the Bill, which we believe, when enacted, will help fortify Hong Kong's position as a premier wealth and asset management hub, particularly by promoting Hong Kong's private equity (PE) fund industry.

We appreciate that this proposed introduction of a tax exemption for carried interest, coupled with the Government's other measures in recent years (e.g. the enactment of the unified tax exemption regime for funds (UFE) in 2019 and the introduction of the limited partnership fund regime (LPF) in 2020), demonstrates the Government's determination and efforts to enhance the legal and tax environment for PE funds and fund managers to set up and operate in Hong Kong. It is particularly encouraging that the Bill proposes a tax "exemption", i.e. 0% profits tax rate, or full exclusion from employment income for salaries tax purposes, for eligible carried interest provided conditions are satisfied. We also appreciate the Government having taken this opportunity to respond to the industry's request in expanding the definition of special purpose entity (SPE) under the UFE, to allow an SPE to hold and administer a wider range of assets (e.g. listed shares), apart from investee private companies (as defined under the UFE).

In addressing some of the industry concerns that remain, we set out our comments towards the Bill as follows for the Government's consideration.

1. Applicability of the tax exemption to global PE funds

For carried interest to qualify for tax exemption, the Bill appears to require that, apart from other conditions, the carried interest arises from profits that are tax-exempt under the UFE. It is unclear whether this means that reliance on the tax exemption under the UFE is a prerequisite.

Clarity in this respect is particularly important for global PE funds. This is because, due to their international networks, many global PE funds, despite having an investment advisory arm in Hong Kong, are unlikely to base their fund managers here. Typically, they will have an investment advisor, or a mixture of investment manager

and investment advisor, rather than a full-fledged fund manager in Hong Kong. In such cases, their investment-related activities in Hong Kong will often be limited, in a way that profits from investments and divestments could be considered as arising from outside Hong Kong, and hence non-taxable under Hong Kong's ordinary tax rules, without relying on the UFE tax exemption, i.e. those profits are non-taxable in Hong Kong, rather than tax-exempt under the UFE per se.

In this regard, if the Bill were to require eligible carried interest to arise from profits that are tax-exempt by relying on the UFE, this would deprive many global PE funds of the tax exemption for carried interest, solely because given their global networks, a full-fledged fund manager model in Hong Kong is not commercially feasible, and those global PE funds' transactions are often arranged in a way that the profits derived therefrom are considered as non-taxable in Hong Kong without relying on the UFE's tax exemption. This can be the case even if a global PE fund may have substantial investment-related activities in Hong Kong.

As global PE funds are important market players and play a vital role in the development of the PE industry, it would not be encouraging if many of them are unable to benefit from the tax exemption for carried interest. Although we understand from the Legislative Council Brief accompanying the Bill that, to prevent tax abuse, the Government intends to require the carried interest to arise from transactions that meet all the relevant tax exemption conditions under the UFE, it seems that the other conditions imposed by the Bill are to a large extent mirroring, or interlinked with, the conditions under the UFE (e.g. the eligible carried interest has to be paid by a "fund" meeting the definition under the UFE; the eligible carried interest has to arise from PE transactions that qualify for essentially the same tax exemption conditions under the UFE, etc.) which may have served the same purpose. In this regard, we recommend that the Government, instead of requiring the eligible carried interest to arise from profits ***that are tax-exempt in accordance with the UFE***, require that eligible carried interest arises from profits ***that meet the tax exemption conditions under the UFE***. This should help leave the door to tax exemption for carried interest open to many global PE funds.

2. Individuals' eligibility for tax exemption for carried interest under global arrangements

For PE funds that have a global presence, it is common for Hong Kong-based team members to occasionally travel overseas to perform deal-related or fund-raising activities in relation to the fund's PE transactions. This a commercial reality that should be catered for, and alone should not fully or partly disqualify the eligible carried interest from the tax exemption. Given the above, we suggest the Government make it clear that investment management services need not be wholly conducted in Hong Kong, and that routine business trips overseas should not place the eligible carried interest outside the tax exemption.

On the other hand, senior deal professionals at global funds are often entitled to carried interest based on a global carry pool, which is calculated based on the performance of Hong Kong and non-Hong Kong deals. If those senior deal professionals are employed in Hong Kong, their employment income is generally wholly subject to Hong Kong salaries tax, while, according to the Bill, the eligible carried interest may only be excluded from employment income to the extent that it is paid out of the eligible carried interest received by or accrued to the qualifying person concerned (i.e. the employing entity of the senior deal professionals, or the employing entity's associated corporation/partnership, in the current context) **which is exempt from profits tax according to the provisions under the Bill**. As such, the parts of the carried interest entitlements of those senior deal professionals that may have arisen from profits derived from non-Hong Kong deals managed by non-Hong Kong (e.g. US or UK) managers of the fund group, which are generally non-taxable in Hong Kong (as not attributable to any activities conducted in Hong Kong) rather than exempt from profits tax by relying on the UFE per se, will, as the Bill stands, not qualify for the tax exemption for carried interest for the purposes of salaries tax as they are not paid out of carried interest arising from "qualifying transactions" that can be exempt from profits tax (as discussed in paragraph 1 above). With a view to enabling those senior deal professionals of global funds to benefit equally from the tax exemption for carried interest, we recommend that the Government allow greater flexibility in this respect.

3. Qualifying transactions

The Bill stipulates that eligible carried interest shall arise from profits derived from qualifying PE transactions, where a qualifying PE transaction generally means a transaction:

- in shares or other securities of a private company;
- in shares (or comparable interests) of a qualifying SPE that holds and administers investee private companies (as defined under the UFE) and no other assets of a class specified in Schedule 16C to the Inland Revenue Ordinance for the purposes of the UFE (Schedule 16C Assets);
- in shares and/or other securities of an investee private company; or
- incidental to the carrying out of a transaction described above (subject to a 5% threshold under the UFE).

It follows that a fund of PE funds, which invests in other PE funds (typically established in the form of a limited partnership rather than a private company) and might also make direct PE investments, may not be able to enjoy the tax exemption, as its carried interest may not arise from a qualifying PE transaction per se. We hope the Government appreciates that funds of PE funds play a very important role in the PE industry, as they pool and channel global investors' capital into the alternative investments ecosystem for PE funds in Asia, which otherwise would likely be out of the direct reach for investors (particularly retail investors). We hence recommend that the tax exemption regime for carried interest also cover funds of PE funds.

Meanwhile, as mentioned above, the Bill separately proposes to expand the definition of an SPE under the UFE to allow an SPE to hold and administer (apart from investee private companies as defined under the UFE) Schedule 16C Assets (e.g. listed shares). However, in defining what constitutes a qualifying PE transaction ***for the purposes of the tax exemption for carried interest*** (above), the Bill stipulates that ***for the tax exemption to apply to carried interest arising from a transaction in shares of an SPE, the SPE must <u>not</u> hold and administer other Schedule 16C Assets***. This seems to suggest that although holding Schedule 16C Assets (other than investee private companies) would not taint the SPE from the tax exemption under the UFE, it would taint the exemption on carried interest arising from a transaction in shares of an SPE. To allow for greater structural flexibility and address the operational needs of PE funds, we suggest the Government re-draft the Bill in a way that even if an SPE holds and administers other Schedule 16C Assets apart from investee private companies, this should not taint the tax exemption on all the carried interest arising from a transaction in that SPE if other conditions are satisfied.

Furthermore, based on the current definition of a qualifying PE transaction, the tax exemption does not apply to carried interest arising from an asset deal undertaken by an SPE (i.e. the SPE selling a real estate investment and distributing the sales proceeds as dividends up the chain to the fund). As such an asset deal undertaken by the SPE followed by a subsequent dividend-up of the sales proceeds is, in essence, no different from a direct sale of the SPE itself, we suggest the Government equally allow a tax exemption for carried interest arising from this type of transaction, provided other conditions are satisfied.

4. Other issues concerning the tax exemption under the UFE

We also take this opportunity to suggest that the Government revisit the tax exemption regime under the UFE and, in particular, address the issue set out below, which may be seen as controversial and unresolved.

<u>Application of tax exemption under the UFE to fixed-income, bond or credit funds</u>

Under the UFE, qualifying transactions, i.e. transactions in Schedule 16C Assets, are tax-exempt provided conditions are satisfied, but income from incidental transactions would be exempt from tax only if this does not exceed 5% of the total trading receipts from qualifying and incidental transactions, i.e. a 5% threshold. If the 5% threshold is exceeded, the tax exemption would not apply to income from incidental transactions, and

such income from incidental transactions would generally be taxable in Hong Kong if sourced in Hong Kong and revenue in nature.

As indicated in its practice notes, the Inland Revenue Department (IRD) has seemingly taken a position that receipts of interest income on securities acquired through "qualifying transactions" are merely incidental transactions, but not "qualifying transactions" per se, which means they are subject to the 5% threshold. This seriously hinders the attractiveness of the UFE (and the tax exemption for carried interest due to its linkage with the UFE) to typical fixed-income, bond or credit funds.

In this regard, we suggest the Government consider whether a legislative amendment (e.g. by stipulating that interest income from the holding of debt securities is also considered as income from qualifying transactions) is possible to address the above issue, so that the UFE (and the tax exemption for carried interest) would be equally attractive to typical fixed-income, bond and credit funds, ensuring a level playing field for all types of funds.

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All in all, we welcome the Government's announcement of the Bill to introduce a tax exemption for carried interest. This should help enhance Hong Kong's competiveness as a leading asset and wealth management hub in the region. We also appreciate the Government's efforts in embarking on a consultation to seek views from the industry and professional bodies with respect to the Bill during the legislative process.

Hong Kong has been moving in the right direction, as evidenced by various initiatives launched by the Government in recent years with a view to promoting Hong Kong's fund and asset management industry. With the upcoming tax exemption for carried interest proposed by the Bill, together with the UFE and LPF that have already come into operation, we hope that a more-friendly tax environment and enhanced legal framework will help attract more funds and investment management and related activities to Hong Kong, thereby creating business opportunities in related professional services that boost Hong Kong's economy.

We look forward to amendments to the Bill to address the above concerns. If you would like to discuss any of the above comments, please do not hesitate to contact the undersigned at (852) 2852 1082, or Roy Phan, our Tax Director, at (852) 2238 7689.

Yours faithfully,
For and on behalf of Deloitte Advisory (Hong Kong) Limited

Anthony Lau
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