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12 April 2021

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

Dear Mr Sin,

**Bills Committee on Inland Revenue (Amendment) (Tax Concessions
for Carried Interest) Bill 2021
Government's Response to Submissions**

I refer to your email dated 26 March 2021 enclosing the submissions from the public on the Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Bill 2021 ("the Bill"). The Government noted that both submissions indicated general support for the Bill and our response to the key issues raised is set out in the following.

Purpose of the Bill

2. The purpose of the Bill is to provide tax concessions for carried interest distributed by eligible private equity ("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.

When designing the parameters for the tax concession regime, we need to fulfil the Organisation for Economic Cooperation and Development's latest international taxation standards (including the anti-Base Erosion and Profit Shifting measures) to ensure that those beneficiaries of the preferential tax regime would undertake core income generating activities in the jurisdiction providing the regime.

Tax exemption condition at the fund level

3. Section 4(2) of the proposed new Schedule 16D provides that, if eligible carried interest arises from profits earned from a specified transaction by a certified investment fund or a special purpose entity ("SPE"), those profits shall be exempt from profits tax in accordance with section 20AN or 20AO of the Inland Revenue Ordinance ("IRO"). This requirement is imposed to fulfil our policy objective to promote management and operation of PE funds in Hong Kong, and ensures that eligible carried interest arises from tax-exempted transaction of a fund to prevent abuse. The above proposed tax treatment has taken into account that, with the commencement of the Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Ordinance 2019 since 1 April 2019, the tax-exempt profits of the fund will not be tainted even if a fund is taxed on its non-qualifying transactions. We should not incentivise funds from carrying out non-qualifying transactions and non-tax-exempted transactions (e.g. speculation of local immovable properties by a fund or via an SPE) by providing tax concessions for carried interest arising from such transactions.

Definition of qualifying employee

4. The term "qualifying employee" is defined in section 8(4) of the proposed new Schedule 16D to mean an individual who is employed by a qualifying person or the associated corporation or associated partnership of a qualifying person, provided that the associated corporation or associated partnership carries on a business in Hong Kong; and the individual is carrying out the duties of the employment by providing investment management services in Hong Kong for, or on behalf of, the qualifying person.

5. Eligible carried interest received by or accrued to a qualifying employee is an income arising in or derived from Hong Kong from an employment of profit. The employment relationship between the qualifying person and the qualifying employee is a vital piece of evidence to establish the role of the individual in providing investment management services in Hong Kong for, or on behalf of, the qualifying person and earning income (including eligible carried interest) in return for the services. Therefore, in the absence of contractual relationship between the individual and the qualifying person concerned, it is doubtful whether the individual really provides investment management services in Hong Kong for, or on behalf of, the qualifying person to the certified investment fund.

6. Furthermore, it is required under section 8(4) of the proposed new Schedule 16D that, if a qualifying employee is employed by an associated corporation or associated partnership of the qualifying person, such associated corporation or associated partnership shall carry on a business in Hong Kong. This ensures that both the qualifying person and the qualifying employee have sufficient connection and nexus with the core income generating activities in Hong Kong in accordance with the international taxation standards.

7. We would also like to clarify that the tax concession arrangement under the Bill is only applicable to carried interest arising in or derived from Hong Kong in return for investment management services performed in Hong Kong. Whether the investment management services performed outside Hong Kong would be accepted as incidental to the provision of investment management services in Hong Kong for, or on behalf of, the qualifying person is a question of fact and depends on the circumstances of each case.

Qualifying transactions

8. Section 4(2)(c) of the proposed new Schedule 16D provides that eligible carried interest must arise from transactions –

- (a) in shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a private company specified under Schedule 16C to the IRO;
- (b) in shares of, or comparable interests in an SPE or an interposed SPE which is solely holding (whether directly or indirectly) and administering one or more investee private companies;
- (c) in shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, an investee private company held by an SPE or an interposed SPE at (b) above; or
- (d) incidental to the carrying out of the qualifying transactions at (a) to (c) above.

9. It is our policy intent to promote the development of PE funds in Hong Kong. Therefore, concessionary tax treatment would be ring-fenced to eligible carried interest arising from qualifying transactions in PE mentioned in paragraph 8 above. If a fund (including a fund investing in other PE funds) carries out the aforementioned qualifying PE transactions directly, eligible carried interest arising from such transactions would be eligible for tax concessions subject to the fulfilment of other conditions. Other than the aforementioned PE transactions, it is not our policy intent to provide tax concessions for carried interest arising from profits-related return derived from transactions in another fund or from other non-PE transactions.

10. Furthermore, Clauses 6 and 7 of the Bill amend sections 20AN and 20AO of the IRO respectively to expand for the purposes of profits tax exemption the eligible classes of assets that may be held and administered by an SPE on behalf of a fund that owns the entity. In particular, Clause 7 amends the definition of SPE in section 20AO(4) of the IRO to make it clear that the entity can hold and administer assets of a class specified in Schedule 16C to the IRO. To prevent funds from circumventing the requirements at paragraph 8 above by carrying out non-qualifying transactions through an SPE or interposed SPEs, we consider it necessary to prevent tax abuse by confining the investment scope of SPEs or interposed SPEs under the carried interest tax concession regime.

Carried interest received by a qualifying person via a special vehicle

11. Carried interest may be structured to be first received by a special vehicle and then passed on to a qualifying person. Whether the special vehicle would be assessed to profits tax in accordance with the principles in section 14 of the IRO is a question of fact and depends on the circumstances of each case. It is not possible to lay down any hard and fast rules as to whether the special vehicle is not chargeable to profits tax. If the special vehicle carries on a trade, profession or business in Hong Kong, the carried interest to be charged is from such trade, profession or business carried on by the special vehicle in Hong Kong, and the carried interest arises in or is derived from Hong Kong, the carried interest received by the special vehicle is subject to profits tax in Hong Kong.

Tax treatment of interest income

12. The views on tax treatment of interest income fall outside of the scope of the Bill. In any event, interest income derived from debt instruments would be treated as transactions incidental to the carrying out of qualifying transactions since the payment of interest to holders of the debt instrument merely gives effect to the rights already attached to the debt instrument. The trading receipts from incidental transactions will be exempted from profits tax, subject to a 5% limit on the total trading receipts as set out in section 20AN(4) of the IRO.

Application of the tax concession regime

13. Subject to the passage of the Bill by the Legislative Council, concessionary tax treatment will apply to eligible carried interest received by, or accrued to, qualifying carried interest recipients on or after 1 April 2020. The Inland Revenue Department and the Hong Kong Monetary Authority will make necessary arrangement to provide for transitional matters in relation to the implementation of the tax concession regime.

Yours sincerely,



(Ms Candy Lau)
for Secretary for Financial Services and the Treasury

c.c. Commissioner of Inland Revenue (Attn: Ms Rosina Lau)
Chief Executive, Hong Kong Monetary Authority (Attn: Mr Kenneth Hui)