

立法會
Legislative Council

LC Paper No. LS34/20-21

**Paper for the House Committee Meeting
on 19 February 2021**

**Legal Service Division Report on
Inland Revenue (Amendment)
(Tax Concessions for Carried Interest) Bill 2021**

I. SUMMARY

- 1. The Bill**

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;
 - (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.
- 2. Public Consultation**

According to the Administration, a four-week industry consultation was conducted from August to September 2020. The financial services industry generally welcomed the proposed tax concessions.
- 3. Consultation with LegCo Panel**

The Panel on Financial Affairs was consulted on 4 January 2021. Members had no objection to the introduction of the Bill into the Legislative Council.
- 4. Conclusion**

No difficulties relating to the legal and drafting aspects of the Bill have been identified. Subject to Members' views, the Bill is ready for resumption of Second Reading debate.

II. REPORT

The date of First Reading of the Bill is 3 February 2021. Members may refer to the Legislative Council ("LegCo") Brief (File Ref.: ASST/3/1/8/1C) issued by the Financial Services and the Treasury Bureau on 27 January 2021 for further details.

Object of the Bill

2. 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;
 - (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 ("SPE") on behalf of a fund that owns the entity; and
 - (c) provide for related and transitional matters.

Background

3. According to paragraphs 4 and 5 of the LegCo Brief, a service provider of a private equity ("PE") fund typically receives as remuneration (a) an annual management fee;¹ and (b) a return linked to the performance of an investment ("carried interest").² 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 2020-21 Budget Speech (paragraph 62) 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

¹ The annual management fee represents a specified percentage of the fund's assets under management under an investment management agreement.

² 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.

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. The Bill is introduced into LegCo to give effect to the above policy initiative.

Provisions of the Bill

5. The Bill proposes to amend Cap. 112 to introduce the tax concession regime in relation to eligible carried interest for (a) qualifying persons and (b) qualifying employees from the provision of investment management services for certain funds or entities, commonly known as PE funds. Details of the proposed tax concessions are summarized in the ensuing paragraphs.

Proposed tax concession regime for eligible carried interest (new Part 6B and Schedule 16D)

6. The Bill proposes to add a new Part 6B to Cap. 112 to provide for the tax concession regime for eligible carried interest (clause 8), and the operational details are set out in the new Schedule 16D (clause 12).

Eligible carried interest

7. "Eligible carried interest" is proposed in section 3(1) of the new Schedule 16D to mean a sum received by, or accrued to, a person by way of profit-related return from the provision of investment management services by the person for an investment fund certified by the Monetary Authority ("certified investment fund") or a "specified entity" (i.e. The Innovation and Technology Venture Fund Corporation incorporated under the Companies Ordinance (Cap. 622)). What would constitute "profit-related return" is elaborated in sections 3(2) and 3(10) of that Schedule, including that the sum is received or accrued after the payment of a return on investments in the fund or entity, and the sum is variable by reference to the profits, etc.

8. The Bill proposes that the tax concessions would apply to eligible carried interest received or accrued on or after 1 April 2020 for any year of assessment commencing on or after that date.

Eligibility for profits tax concessions (Part 2 of new Schedule 16D)

9. The major proposed conditions that have to be satisfied for the proposed profits tax concessions are set out in sections 4(2) and 5 of the new Schedule 16D. These conditions are summarized below:

- (a) the person claiming the tax concessions is a "qualifying person",³ which is proposed to include, among others, a corporation licensed under Part V of the Securities and Futures Ordinance (Cap. 571) to carry on, or an authorized financial institution registered under that Part for carrying on, a business in any regulated activity in Part 1 of Schedule 5 to Cap. 571;
- (b) the eligible carried interest is received from a "qualifying payer", which is proposed to mean a certified investment fund, its associated corporation or partnership, or a specified entity;
- (c) the eligible carried interest arises from profits on investments, profits, etc. that are earned from certain transactions, e.g. transactions in shares, stocks, debentures, etc. of or issued by a private company, shares of or comparable interests in a SPE, and shares, stocks, debentures, etc. of or issued by an investee private company;
- (d) the investment management services⁴ are carried out or arranged to be carried out in Hong Kong;
- (e) the average number of full-time employees of the qualifying person in Hong Kong carrying out the investment management services should be adequate in the opinion of the Commissioner of Inland Revenue ("Commissioner") and be two or more; and
- (f) the total amount of operating expenditure incurred in Hong Kong is adequate in the opinion of the Commissioner and amounts to HK\$2 million or more.

10. Upon satisfying all the above conditions, the qualifying person's assessable profits chargeable to profits tax in respect of the net eligible carried interest would be calculated in accordance with section 6 at the rate specified in section 7, which is proposed to be 0%.

Eligibility for salaries tax concessions (Part 3 of new Schedule 16D)

11. To be eligible for the proposed salaries tax concessions, an individual would have to be a "qualifying employee", which is proposed in section 8(4) of the new Schedule 16D to mean an individual (a) who is employed by a qualifying person or its associated corporation or associated partnership carrying on business in Hong Kong, and (b) who is carrying out the duties of the employment by

³ See section 4(3) of the new Schedule 16D.

⁴ "Investment management services" in relation to a certified investment fund or a specified entity are proposed in section 1 of the new Schedule 16D to include seeking funds from (potential) external investors, researching and advising on potential investments, acquiring, managing or disposing of property or investments, and assisting an entity in which the fund or entity invested to raise funds.

providing investment management services in Hong Kong for or on behalf of the qualifying person. Moreover, according to section 8(2) of that Schedule, the assessable income would have to be accrued to him from an employment to provide investment management services for or on behalf of a qualifying person for a certified investment fund or specified entity.

12. Upon satisfying all the above conditions, the qualifying employee's assessable income from the employment chargeable to salaries tax would be calculated in accordance with section 8(3) of the new Schedule 16D, and the percentage of eligible carried interest to be excluded from the calculation is proposed to be 100% under section 9.

Power to amend the new Schedule 16D

13. The new Part 6B also seeks to empower the Secretary for Financial Services and the Treasury to amend sections 2, 5(3), 7 and 9 of the new Schedule 16D by notice published in the Gazette, relating to the meanings of "certified investment fund", "qualifying payer" and "specified entity", the level of substantial activities required for the profits tax concessions as stated in paragraphs 9(e) and (f), and the rate and percentage to be applied for the profits tax and salaries tax concessions respectively. Such notice would be subsidiary legislation subject to scrutiny of LegCo pursuant to the negative vetting procedure.

Proposed expansion of eligible classes of assets held and administered by SPE

14. Currently, under section 20AN of Cap. 112, certain funds are exempt from payment of profits tax (upon satisfying certain conditions) in respect of profits earned from, among others, transactions in assets of a class specified in Schedule 16C; whereas under section 20AO of Cap. 112, a SPE is exempt from paying profits tax in relation to certain transactions specified under section 20AO, which do not include transactions in assets of a class specified in Schedule 16C.

15. The Bill proposes to amend sections 20AN and 20AO of Cap. 112. The effect of the proposed amendments, if passed, would be to expand, for the purposes of profits tax exemption, the eligible classes of assets that may be held and administered by a SPE on behalf of a fund that owns the entity, to include assets of a class specified in Schedule 16C (clauses 6 and 7). Consequentially, Schedule 16C is proposed to be amended to include references to section 20AO and the new Schedule 16D (clause 11).

Other related and transitional provisions

16. The Bill also proposes certain related amendments including (a) provisions enabling the Commissioner to seek advice from the Monetary Authority, and (b) provisions on anti-tax avoidance. Relevant transitional provisions have also been proposed in the Bill.

Commencement

17. The Bill, if passed, would come into operation on the day on which it is published in the Gazette as an Ordinance.

Public Consultation

18. According to paragraphs 6 and 27 of the LegCo Brief, the Administration conducted a four-week industry consultation on the proposed tax concessions from August to September 2020. The financial services industry generally welcomed the proposal and suggested a more relaxed regime, lower substantial activities requirements and a more competitive concessionary tax rate. According to the Administration, the industry's feedback has been taken into account in preparing the Bill.

Consultation with LegCo Panel

19. As advised by the Clerk to the Panel on Financial Affairs ("Panel"), on 4 January 2021, the Administration briefed the Panel on the legislative proposals to: (a) provide tax concessions for carried interest distributed by eligible PE funds operating in Hong Kong; and (b) enhance the profits tax regime for privately offered funds. Members had no objection to the introduction of the Bill into LegCo. Members discussed various issues including the benefits to be brought by the proposals and the estimated revenue forgone arising from the proposed carried interest tax concession regime, and the Administration's measures to develop Hong Kong as a premier PE fund hub.

Conclusion

20. No difficulties relating to the legal and drafting aspects of the Bill have been identified. Subject to Members' views, the Bill is ready for resumption of Second Reading debate.

Prepared by

Doreen WAN
Assistant Legal Adviser
Legislative Council Secretariat
17 February 2021