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Paper for the House Committee meeting on 16 April 2021

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

Purpose

This paper reports on the deliberations of the Bills Committee on Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Bill 2021 ("the Bills Committee").

Background

2. Private equity ("PE") fund is a collective investment scheme with its underlying assets primarily consisting of equity securities of private companies¹ 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.

¹ 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.

3. A service provider of a PE fund typically receives as remuneration an annual management fee,² and a return linked to the performance of an investment ("carried interest").³ 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.

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

5. The Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Bill 2021 ("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;
- (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.

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

³ 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.

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 16 of the Legal Service Division Report on the Bill (LC Paper No. LS34/20-21).

Commencement

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

The Bills Committee

7. At the House Committee meeting held on 19 February 2021, Members agreed to form a Bills Committee to scrutinize the Bill. Hon CHEUNG Kwok-kwan was elected Chairman of the Bills Committee. The membership list of the Bills Committee is in **Appendix I**.

8. The Bills Committee has held one meeting with the Administration and invited written views from the public and relevant organizations. The Bills Committee has received two submissions. A list of the organizations which have provided written views to the Bills Committee is in **Appendix II**. The Administration has provided a written response to the issues raised in the deputations' submissions.⁴

Deliberations of the Bills Committee

9. Members of the Bills Committee generally support the Bill and the objectives it seeks to achieve. The major issues and concerns raised by members during the scrutiny of the Bill are summarized in the ensuing paragraphs.

Discussion related to "fund"

Definition of "fund"

10. As the objective of the Bill is to encourage more overseas PE funds to move to Hong Kong, a member has asked whether the Administration would widen the definition of "fund" to include investment funds with a single investor ("fund of one"). He points out that fund of one is a popular investment structure adopted by pension funds and multinational corporations. The

⁴ The Administration's response can be found at [LC Paper No. CB\(1\)783/20-21\(01\)](#).

Administration has explained that the definition of "fund" under section 20AM of Cap. 112 is drawn up taking into consideration the definition of "collective investment scheme" in section 1 of Part 1 of Schedule 1 to Securities and Futures Ordinance (Cap. 571). To qualify as a fund, an arrangement should satisfy a number of requirements, such as that the property is managed as a whole by or on behalf of the person operating the arrangements; and/or the contributions of the participating persons and the profits or income from which payments are made to them are pooled under the arrangement. The Inland Revenue Department ("IRD") has issued a Departmental Interpretation and Practice Notes ("DIPN") which covers the interpretation and practices in relation to the profits tax exemption for privately-offered funds. This DIPN also specifies that, in certain circumstances, an arrangement may be considered as a fund even if it has only one investor at its initial stage of operation. The actual eligibility of an arrangement as a fund would have to be determined according to the specific circumstances of the individual case.

How a private equity fund can be eligible for the proposed tax concession

11. A member has sought clarification on whether a PE fund registered and operating overseas would be able to benefit from the regime by simply registering in Hong Kong and meeting the minimum number of full-time employees and the minimum amount of operating expenditure requirements under the Bill, while retaining a substantial portion of its operations and personnel in another jurisdiction.

12. The Administration has explained that, while it is the Administration's objective to encourage overseas PE funds to domicile in Hong Kong, any tax concession introduced in Hong Kong should comply with the latest international taxation standards including the anti-Base Erosion and Profit Shifting ("BEPS") measures of the Organisation for Economic Co-operation and Development ("OECD"). In determining whether a preferential tax regime meets the international standards on counteracting BEPS, OECD would take into account whether the regime could meet the substantial activities requirements to ensure that those beneficiaries of the preferential tax regime would undertake core income generating activities in the jurisdiction providing the regime. Given the above international taxation standards, many jurisdictions have tightened up their tax regimes, and as a result, many industry players are considering to align their fund structures with business activities onshore. The Administration is trying to take this window of opportunity to encourage funds formation and operation in Hong Kong by offering more attractive tax concession policies, and to this end, the Administration would consider introducing a legal framework that would facilitate PE funds to re-domicile in Hong Kong.

Special purpose entities set up by a fund

13. At present, SPEs are established under a fund to hold and administer investee private companies, but not other financial assets. The Bill, if passed, would amend Cap. 112 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. A member has queried whether an SPE established by a privately-offered fund would be regarded as a tax resident of Hong Kong.

14. The Administration has advised that SPEs are established solely for the purposes of holding (whether directly and indirectly) and administering one or more investee private companies. They are not allowed to carry out any trade or activities. As SPEs were wholly or partially owned by funds, IRD would take into account the location of central management and control of the relevant fund in considering an SPE's tax resident status.

Discussion related to profits tax and salaries tax concessions

Profits from the sale of an investment in a private company through an initial public offering

15. A service provider of a PE fund is commonly remunerated based on an annual management fee and a return linked to the performance of an investment (described as "carried interest") typically upon the disposal of the investment. Members note that the Administration proposes to provide tax concessions for "eligible" carried interest issued by PE funds operating in Hong Kong, subject to the fulfilment of certain conditions. The Administration also proposes to define "eligible carried interest" as a sum received by, or accrued to, a person by way of a profit-related return subject to a hurdle rate.⁵

16. A member has enquired whether a carried interest arising from profits earned from the sale of the investment in a private company through an initial public offering ("IPO") would be eligible for tax concessions.

17. The Administration has explained that privately-offered funds, including PE funds, are exempt from the payment of profits tax in respect of assessable profits derived from qualifying transactions in local and overseas private companies, including a PE fund exited through an IPO, subject to meeting the relevant exemption conditions. IRD has issued a DIPN which clarifies that, if a fund sells its investment in the investee private company through an IPO, it is in substance no different from a transaction in listed securities or a transaction in

⁵ Hurdle rate means a preferred rate of return on investments in the fund that is stipulated in the agreement governing the operation of the fund.

securities of an investee private company. The fund would continue to be eligible for profits tax exemption in respect of the divestment if the exemption conditions remain satisfied.

Profits tax treatment of eligible carried interest

18. Members note that, according to section 5(3) of the proposed new Schedule 16D, two conditions have to be satisfied for the proposed profits tax concession to apply to a person in relation to eligible carried interest received by, or accrued to, the person from the provision of investment management services for a certified investment fund or a specified entity for a year of assessment. These conditions are: during the basis period for each year of assessment falling within the applicable period, (a) the average number of full-time employees in Hong Kong carrying out the investment management services concerned should be adequate in the opinion of the Commissioner of Inland Revenue ("Commissioner") and be two or more; and (b) the total amount of operating expenditure incurred in Hong Kong for the provision of the investment management services concerned is adequate in the opinion of the Commissioner and amounts to HK\$2 million or more.

19. A member has asked how these conditions are set and whether references have been made to the *modus operandi* of existing PE funds operating in Hong Kong. The member has also queried whether the Commissioner could require the employment of more than two local employees or impose higher operating expenditure requirements. The Administration has responded that the conditions are proposed after taking into account the local market landscape such as the total operating expenditure of PE funds, and the views gathered during an industry consultation on the preliminary proposal from August to September 2020.

20. The Administration has further advised that the Bill only sets out the minimum requirements for eligibility for profits tax concessions. Depending on the facts and circumstances of each case, the Commissioner might exercise judgment on whether the number of full-time employees and the total amount of local operating expenditure of the qualifying persons are adequate and proportionate to their operation in Hong Kong.

Application of the proposed tax treatment of eligible carried interest

21. Members note that part 6 of the proposed new Schedule 16D seeks to provide that the tax treatment of eligible carried interest under that Schedule would apply in relation to eligible carried interest received by, or accrued to, a qualifying person or a qualifying employee on or after 1 April 2020, for any year of assessment commencing on or after that date.

22. Members have commented that allowing the period to which tax concessions would apply to be backdated seems quite generous. Some members have pointed out that in some previous tax concession proposals there had been requests that such tax concessions should apply to profits made in a similar period before they took effect, but the requests had been rejected by the Administration. They have queried whether the current proposal is consistent with the previous practice. The Administration has responded that the current proposal is a conscious decision to attract overseas PE funds to move to and operate in Hong Kong as early as possible.

Salary tax concessions for qualifying employees

23. Members note that the Administration proposes to provide concessionary tax treatment to "qualifying employees" within the meaning of section 8(4) of the proposed new Schedule 16D. According to this provision, a qualifying employee should be employed by a qualifying person or its associated corporation or associated partnership which carries on a business in Hong Kong. A member has enquired whether the definition of "qualifying employees" should be widened to include a person who is employed by an overseas associated corporation of the qualifying person and carries out investment management services in Hong Kong.

24. Members have also asked whether a local employee of a qualifying person would be considered as a qualifying employee and eligible for salaries tax concessions if the carried interest is paid by an overseas associated corporation of the qualifying person.

25. The Administration has explained that any tax concession introduced in Hong Kong should comply with the latest international taxation standards including the anti-BEPS measures of OECD. To be eligible for the proposed salaries tax concessions, an individual has to be a qualifying employee as defined under section 8(4) of the proposed new Schedule 16D. This means that the individual is employed by a qualifying person or its associated corporation or associated partnership carrying on a business in Hong Kong, and that individual is carrying out the duties of employment by providing investment management services in Hong Kong for or on behalf of the qualifying person. An individual who is employed by an overseas company not carrying on a business in Hong Kong would not be eligible for salaries tax concessions under the regime.

26. The Administration has further explained that, subject to fulfilment of conditions at section 8 of the proposed new Schedule 16D, a qualifying employee's assessable income from the employment chargeable to salaries tax would be calculated in accordance with section 8(3) of the proposed new Schedule 16D. According to section 8(2) of that Schedule, the assessable

income would have to be accrued to the qualifying employee from an employment to provide investment management services in Hong Kong for or on behalf of a qualifying person for a certified investment fund or a specified entity. The qualifying employee should provide relevant documentary proof to the Commissioner in relation to the distribution of eligible carried interest if the carried interest in question was not distributed by a qualifying payer directly.

Financial implication of the proposed regime

27. Members have also expressed concerns about the estimated revenue forgone arising from the proposed regime. They have queried about the number of PE firms that would be able to enjoy the tax concessions after implementing the regime. The Administration has explained that currently there are about 581 PE firms operating in Hong Kong. The number of PE funds is expected to increase upon implementation of the regime. The growth in PE funds is also expected to stimulate demands for investment management services and related professional services. That said, the Administration has difficulties in estimating at this stage the number of PE funds that would be attracted to operate and be managed in Hong Kong under the regime.

28. The Administration has further advised that, for funds being managed in Hong Kong, since carried interest received by their investment management service providers is chargeable to profits tax together with other service income (e.g. management fees) derived from investment management services rendered in Hong Kong, IRD has not maintained a separate breakdown of tax revenue arising from carried interest in its database. Many PE funds and their investment management service providers are currently carrying out their business and investment management activities offshore, and thus they are not subject to taxation in Hong Kong. The Administration is therefore not able to provide an estimate of the financial implications of the regime accurately.

29. A member has commented that the Administration should assess the effectiveness of the regime and should keep relevant records, including on the number of PE funds attracted to operate in Hong Kong, the number of full-time employees employed and the total amount of local operating expenditure incurred by the qualifying persons in Hong Kong, and the revenue forgone resulting from the regime. Members request the Administration to report the relevant findings to LegCo in due course.

Proposed amendments to the Bill

30. Neither the Bills Committee nor the Administration intends to propose amendments to the Bill.

Resumption of the Second Reading debate on the Bill

31. The Bills Committee supports the resumption of the Second Reading debate on the Bill at the Council meeting of 28 April 2021.

Advice sought

32. Members are invited to note the deliberations of the Bills Committee.

Council Business Division 1
Legislative Council Secretariat
15 April 2021

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

Membership List

Chairman Hon CHEUNG Kwok-kwan, JP

Members Hon WONG Ting-kwong, GBS, JP
Hon Paul TSE Wai-chun, JP
Hon Christopher CHEUNG Wah-fung, SBS, JP
Hon Holden CHOW Ho-ding
Hon CHAN Chun-ying, JP

(Total : 6 members)

Clerk Mr Daniel SIN

Legal Adviser Ms Doreen WAN

**Bills Committee on Inland Revenue (Amendment)
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List of organizations from which the Bills Committee has received views

1. The Taxation Institute of Hong Kong
2. Deloitte Advisory (Hong Kong) Limited