

**For discussion
on 4 January 2021**

Legislative Council Panel on Financial Affairs

Tax concession for carried interest

PURPOSE

This paper briefs Members on the legislative proposals to provide tax concession for carried interest distributed by eligible private equity (“PE”) funds operating in Hong Kong and related matters.

BACKGROUND

2. 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. In recent years, 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. PE funds play a pivotal role in channelling capital, talents and expertise into corporations, in particular start-ups in the innovation and technology sector. In 2019, Hong Kong ranked second in Asia after the Mainland in terms of the total capital under management by PE funds (excluding real estate funds), which amounted to US\$161 billion².

¹ There are different investment strategies for 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.

² Source: Asian Venture Capital Journal.

3. The Government has spared no efforts in developing Hong Kong as a premier PE fund hub, including the establishment of a limited partnership fund regime to meet the operational needs of PE funds which commenced operation on 31 August 2020³. Moreover, since 1 April 2019, privately-offered funds, including PE funds, are exempted from the payment of profits tax in respect of assessable profits derived from eligible transactions in local and overseas private companies, subject to meeting the relevant exemption conditions.

4. Regarding the taxation of the service providers of the PE fund, a typical PE fund pays, broadly speaking, the following remuneration –

- (a) an annual management fee at a specified percentage of the fund's assets under management under an investment management agreement; and
- (b) a return linked to the performance of an investment (described as “carried interest”) typically upon the disposal of the investment after it has been held for a period of time and subject to a hurdle rate⁴.

Management fee and carried interest, if derived from investment management services rendered in Hong Kong, will be chargeable service income for profits tax or chargeable employment income for salaries tax (as the case may be).

5. Given that tax treatment is one of the key factors influencing the choice of jurisdiction for fund domiciliation and operations, it is announced in the 2020-21 Budget Speech that we plan to provide tax concession for carried interest issued by PE funds operating in Hong Kong subject to the fulfilment of certain conditions, with a view to

³ 50 limited partnership funds have been set up in Hong Kong from September to November 2020.

⁴ Broadly speaking, carried interest will generally be distributed subject to the return from the investments of the fund meeting certain hurdle rate. Hurdle rate refers to the preferred rate of return on investments in the fund which is stipulated in the agreement governing the operation of the fund.

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.

LEGISLATIVE PROPOSAL

6. A task force, led by the Financial Services and the Treasury Bureau (“FSTB”) and comprising members from the Inland Revenue Department (“IRD”), Hong Kong Monetary Authority (“HKMA”) and Securities and Futures Commission (“SFC”), has examined how tax concession could be applied to carried interest distributed by PE funds. An industry consultation was conducted from August to September 2020 to gauge the industry’s views. Having considered the comments received, the proposed parameters and eligibility criteria for the tax concession regime for carried interest are summarised in the ensuing paragraphs.

Eligible Carried Interest

7. In order to differentiate carried interest from other types of management fee / remuneration received by investment professionals, we propose to define “eligible carried interest” as a sum received by or accrued to a person by way of profit-related return subject to a hurdle rate which is a preferred rate of return on investments in the fund which is stipulated in the agreement governing the operation of the fund. The term “profit-related return” shall encompass three conditions –

- (a) the eligible carried interest must arise only if there are profits for a period on the investments, or on particular investments, made for the purposes of the certified investment fund, or there are profits arising from a disposal of investment of the fund (see paragraph 8 below);

- (b) the eligible carried interest paid would vary by reference to the profits⁵; and
- (c) the returns to external investors are also determined by reference to the same profits.

Qualifying Carried Interest Payer

8. We propose that tax concession would only apply to eligible carried interest distributed by a fund which falls within the meaning of “fund” under section 20AM of the Inland Revenue Ordinance (Cap. 112) (“IRO”). The fund must be certified by the HKMA (“certified investment fund”) (as detailed in paragraphs 15 and 16 below) and, in the case of a non-resident fund, an authorised local representative must be appointed, who will be responsible for providing the necessary particulars and information to the IRD and the HKMA on behalf of the fund.

9. Separately, under the Innovation and Technology Venture Fund (“ITVF”) Scheme launched by the Innovation and Technology Commission, The Innovation and Technology Venture Fund Corporation (“the ITVF Corporation”) would co-invest with selected venture capital funds as co-investment partners in eligible local innovation and technology start-ups and pay a return to its co-investment partners (and investment managers), amounting to 35% of the realised capital gain upon the sale of the ITVF Corporation’s shares in the start-ups. The nature of this return is similar to that of carried interest. In this connection, we therefore propose that the ITVF Corporation can be included as a qualifying carried interest payer and the return distributed by the ITVF Corporation will be eligible for tax concession under the tax concession regime for carried interest.

⁵ If there is no significant risk that a sum of at least a certain amount would not be received by or accrued to the person concerned, the said amount is not regarded as “carried interest”. Section 809EZC(3)(b) of the Income Tax Act 2007 of the United Kingdom provides the “no significant risk” condition which aims to catch management fees disguised as carried interest, i.e. sums which are in substance virtually certain to arise.

Qualifying Transactions of Certified Investment Funds

10. In line with our policy objective to promote the development of PE funds in Hong Kong, concessionary tax treatment would be ring-fenced to eligible carried interest arising from qualifying transactions in PE only. We propose that, for tax concession to apply, eligible carried interest must arise from transactions⁶ –

- (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 or comparable interests of a special purpose entity or interposed special purpose entity 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 a special purpose entity or interposed special purpose entity at paragraph 10(b) above; or
- (d) incidental to the carrying out of the qualifying transactions at paragraphs 10(a) to (c) above⁷.

Moreover, in order to prevent tax abuse, the qualifying transactions have to meet all the relevant tax exemption conditions under the profits tax regime for privately offered funds under sections 20AM to 20AY of the IRO before the eligible carried interest arising from the transactions concerned is eligible for tax concession.

⁶ Depending on the facts and circumstances of each case, carried interest derived from hedging transaction may be eligible for tax concession if the hedging transaction would form part and parcel of the PE transaction and the profits on the hedging transaction are embedded in the profits or loss on the PE transaction for the calculation of carried interest.

⁷ As provided under section 20AN(4) of the IRO, the trading receipts from incidental transactions shall not exceed 5% of the total trading receipts from qualifying transactions and incidental transactions.

Qualifying Carried Interest Recipients

11. We propose that the following persons providing investment management services (as defined in paragraph 12 below) to a certified investment fund or the ITVF Corporation in Hong Kong, or arranging such services to be carried out in Hong Kong, should be eligible for the concessionary tax treatment –

- (a) a corporation licensed under Part V of the Securities and Futures Ordinance (Cap. 571) (“SFO”) or an authorised financial institution registered under that Part for carrying on a business in any regulated activity as defined in Part 1 of Schedule 5 to the SFO;
- (b) a person⁸, who does not fall in paragraph 11(a) above, providing investment management services in Hong Kong to a certified investment fund which is a “qualified investment fund”⁹ or the ITVF Corporation, or arranging such services to be carried out in Hong Kong; and
- (c) an individual deriving assessable income from the employment with the qualifying persons referred to in paragraph 11(a) or (b) above or their associated corporation or partnership¹⁰ by providing investment management services in Hong Kong to the certified investment funds or the ITVF Corporation on behalf of the qualifying persons.

⁸ Including a natural person, corporation, partnership, trustee, whether incorporated or unincorporated, or body of persons.

⁹ A “qualified investment fund” is defined under section 20AN(6) of the IRO as a fund with at least five investors and meeting certain requirements over capital commitments and distribution of the net proceeds.

¹⁰ If the individual is employed by the associated corporation or associated partnership of the qualifying person, the associated corporation or associated partnership shall carry on a business in Hong Kong.

Provision of Investment Management Services

12. We propose that, to be eligible for the concessionary tax treatment, the eligible carried interest must be derived from the provision of investment management services in Hong Kong to a certified investment fund or the ITVF Corporation. The investment management services must be provided in Hong Kong in view of the policy objective to attract more PE funds to operate in Hong Kong. Such services include –

- (a) seeking funds for the purposes of the certified investment fund from external investors and potential external investors;
- (b) researching and advising on potential investments to be made for the purposes of the certified investment fund or the ITVF Corporation;
- (c) acquiring, managing or disposing of property and investments for the purposes of the certified investment fund or the ITVF Corporation; and
- (d) acting for the purposes of the certified investment fund with a view to assisting an entity in which the fund has made an investment to raise funds.

Substantial Activities Requirements

13. Our proposal shall be in compliance with the Organisation for Economic Co-operation and Development (“OECD”)’s latest international taxation standards, including anti-base erosion and profit shifting (“BEPS”) measures. In determining whether a preferential tax regime meets the international standards on counteracting BEPS, the OECD will take into account whether the regime can 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.

14. We propose that, in order for concessionary tax treatment to apply, qualifying carried interest recipients at paragraph 11(a) or (b) above must have, in the opinion of the Commissioner of Inland Revenue, adequate number of qualified full-time employees and operating expenditure incurred in Hong Kong for the relevant years of assessment¹¹, including –

- (a) the average number of full-time employees in Hong Kong who carry out the investment management services as set out in paragraphs 12(a) to (d) above during the basis period for each year of assessment concerned shall be two or more; and
- (b) the operating expenditure incurred in Hong Kong for the provision of the investment management services as set out in paragraphs 12(a) to (d) above during the basis period for each year of assessment concerned shall be HK\$2 million or more.

The HKMA’s Certification and On-going Monitoring Mechanism

15. To prevent tax abuse, the HKMA will administer a certification scheme and funds¹² will have to go through a certification process before concessionary tax treatment will apply to their eligible carried interest distributions. To apply for certification, a fund or the local authorised representative of a non-resident fund should submit an application to the HKMA, together with relevant documents and information as required by the HKMA. The HKMA will assess, based on the information provided, whether the fund makes PE investment and whether the local employment and local spending requirements of the carried interest recipients are likely to be met. A letter of certification will be issued by the HKMA if it is satisfied that the relevant criteria are met.

¹¹ Covering the period from the date when the qualifying carried interest recipient begins to perform investment management services to the certified investment fund or the ITVF Corporation to the date when the carried interest is received by or accrued to the qualifying carried interest recipient.

¹² The intention is to cover PE funds with different investment strategies so long as they are genuine investment funds, except for the ITVF Corporation established by the Government.

16. In a particular year of assessment where there is a distribution of eligible carried interest, an external auditor should be engaged to verify that the relevant substantial activities requirements imposed on the carried interest recipients are met in the relevant year(s) of assessment, and that the distribution fulfils the conditions under the tax concession regime. The auditor's report should be kept at the fund's local office or with the local authorised representative of a non-resident fund for inspection if needed. The IRD may seek advice from the HKMA in order to ascertain whether, among others, an activity constitutes an investment management service, a sum may be eligible carried interest and an entity is a certified investment fund. In addition, the qualifying carried interest recipients and certified investment fund shall provide information to the Commissioner of Inland Revenue in relation to the distribution of eligible carried interest and keep sufficient records.

Deduction of Expenses and Loss Not Available to Set Off

17. For qualifying carried interest recipients subject to profits tax (i.e. qualifying carried interest recipients at paragraph 11(a) or (b) above), we propose that only the net carried interest after deducting any outgoings and expenses and depreciation would be eligible for the tax concession. Also, any loss sustained is not available for set off against any of the assessable profits for the year or any subsequent year of assessment if the concessionary tax rate is zero.

Anti-avoidance Provisions

18. To prevent tax abuse, if the Commissioner of Inland Revenue is satisfied that the main purpose, or one of the main purposes, of a person entering into the arrangement is to obtain a tax benefit, the concessionary tax treatment would not apply to the person concerned. Moreover, we will specify in the legislation that management fee (even if disguised as eligible carried interest) received by qualifying carried interest recipients would not be eligible for tax concession.

Concessionary Tax Rate

19. We propose that eligible carried interest would be charged at profits tax rate of 0%. On the other hand, 100% of eligible carried interest would be excluded from the employment income for the calculation of salaries tax. The proposal would enhance our competitiveness in attracting PE funds to set up and be managed in Hong Kong.

OTHER MATTERS

20. In addition to the proposed tax concession regime for carried interest, we propose to make certain enhancements to the profits tax regime for privately offered funds in order to facilitate the operation of funds in Hong Kong. At present, it is common for funds to hold financial assets other than private companies using special purpose entities (“SPEs”) established by the fund. However, an “SPE”, as currently defined under the IRO, is only allowed to hold and administer investee private companies, but not other financial assets. To address the sector’s concern, we propose to –

- (a) allow an SPE to hold and administer assets of a class specified in Schedule 16C to the IRO; and
- (b) allow an SPE to carry out transactions in such assets on behalf of the fund.

FINANCIAL IMPLICATIONS

21. The proposed tax concession regime for carried interest seeks to attract more PE funds to operate in Hong Kong, thereby generating more demands for investment management services, relevant professional services and related activities. It is difficult to estimate the revenue forgone arising from the carried interest tax concession regime as many PE funds are currently carrying out their business and investment management activities offshore. On the other hand, if more PE funds will be

attracted to operate in Hong Kong, other service income (including management fees) or employment income received by qualifying carried interest recipients for providing investment management services in Hong Kong and service fees received by other professionals for providing professional services (e.g. legal, banking and accounting services) to the PE funds and investment managers in the course of a trade, profession or business carried on in Hong Kong will be chargeable to tax in Hong Kong. After the implementation of the proposed tax concession, the Government will assess its effectiveness on an ongoing basis to ensure that the overall objective of consolidating Hong Kong's position as Asia's premier fund hub for PE and thereby benefiting the economy as a whole is achieved.

WAY FORWARD

22. We are formulating the legislative proposals concerned and our target is to introduce the amendment bill into the Legislative Council ("LegCo") in late January 2021. Subject to the passage of the amendment bill by LegCo, the concessionary tax treatment will take retrospective effect and apply to eligible carried interest received by or accrued to qualifying carried interest recipients on or after 1 April 2020.

ADVICE SOUGHT

23. Members are invited to comment on the proposal as set out from paragraphs 6 to 20 above.

**Financial Services and the Treasury Bureau
December 2020**