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方達律師事務所

HONG KONG PROPOSES 0% TAX RATE ON CARRIED INTEREST

Authors:



Richard Guo
Partner, Fangda Partners
richard.guo@fangdalaw.com



Yue Zhang
Partner, Fangda Partners
yue.zhang@fangdalaw.com



Willa Chan
Associate, Fangda Partners
willa.chan@fangdalaw.com

On 4 January 2021 Hong Kong's Legislative Council published a paper authored by the Financial Services and the Treasury Bureau under the title "Tax concession for carried interest", which aims to brief members of the Legislative Council on the legislative proposals to provide 0% tax concession for carried interest distributed by eligible private equity funds operating in Hong Kong (the "**Proposal**").

If, therefore, you are already managing or proposing to launch a private equity fund, you should strongly consider managing your fund from Hong Kong in order to benefit from the proposed 0% tax on eligible carried interest. It is expected that legislative amendments will be introduced to the Legislative Council for passage in late January 2021, and once the amendment bill is passed, this regime 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.

Background

The Hong Kong government has been striving to strengthen Hong Kong as an international asset and wealth management center. As part of such efforts, a unified profits tax regime for funds domiciled offshore and in Hong Kong came into operation on 1 April 2019, and the Hong Kong Limited Partnership Fund regime was launched on 31 August 2020.

Since the launch of Hong Kong Limited Partnership Fund regime, the private equity industry has been calling for certainty on the tax treatment on carried interest and for the relaxation of the existing tax arrangement in order to attract more investment management and related activities in Hong Kong.

With a view to attracting more private equity funds to domicile and operate in Hong Kong with more investment management and related activities, the Financial Secretary announced in the 2020-21 Budget Speech that the government planned to provide a tax concession for carried interest distributed by private equity funds operating in Hong Kong, subject to the fulfilment of certain conditions. This Proposal is the most recent step undertaken by the Hong Kong government towards that objective.

Why is the Proposal important and what does it seek to address?

Currently under the Hong Kong Inland Revenue Ordinance, management fees and carried interest, if derived from investment management services rendered in Hong Kong, will be chargeable service income for profits tax (subject to a tax rate of 16.5% for corporations and 15% for unincorporated businesses if over HK\$2 million) or chargeable employment income for salaries tax (subject to progressive rate at up to 17% or a standard rate of 15%).

Under the Proposal, eligible carried interest would be charged at profits tax rate of 0% (instead of a typical 16.5% for corporations), and 100% of eligible carried interest would be excluded from the employment income for the calculation of salaries tax. The government believes that the Proposal will enhance Hong Kong's competitiveness in attracting private equity funds to set up and be managed in Hong Kong.

What types of funds may be eligible for the proposed carried interest tax concession in Hong Kong?

Private equity funds and beyond

The Proposal seeks to limit the concessionary tax treatment on carried interest to eligible carried interest arising from qualifying transactions in private equity only, in line with the Hong Kong government's policy objective to promote the development of private equity funds in Hong Kong.

Eligible carried interest must arise from qualifying transactions in shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a private company (whether incorporated in or outside Hong Kong, but not other corporate forms, such as trusts and partnerships) or in shares or comparable interest of special purpose entities holding and administering such private companies, or incidental to the carrying out of the foregoing transactions.

We note that although the stated policy objective is to promote private equity funds in Hong Kong, based on the descriptions set forth in the Proposal, we believe that, assuming other conditions are met, carried interest recipients of *venture capital funds*, *credit funds*, and *real estate funds* may likely be beneficiaries of the carried interest tax concession under the Proposal as well.

Hedge funds not eligible

Hedge fund managers that primarily transact in securities or instruments issued by publicly listed companies will not be able to enjoy the benefit of the carried interest tax concession for the foregoing reason.

The Proposal noted that the tax concession benefit only applies to hedging transactions in very limited circumstances when such hedging transactions form part of the private equity transactions and the profits from such hedging transactions are embedded in the profits or loss on the private equity transaction for calculation of the carried interest.

Not limited to Hong Kong domiciled funds

It is noteworthy that in the Proposal there is a specific reference to "non-resident fund", which appears to enable carried interest derived from funds that are domiciled outside of Hong Kong to be eligible for the tax concession. Such non-resident fund needs to appoint an authorized local representative who will be responsible for providing the necessary particulars and information to the Inland Revenue Department ("**IRD**") and the Hong Kong Monetary Authority ("**HKMA**") on behalf of the fund.

Certification by HKMA required

In order to be eligible for the tax concession treatment, a fund must be certified by the HKMA and subject to ongoing monitoring and assessment by the HKMA and IRD. It remains to be seen what kind of detailed criteria for such certification will be imposed by the HKMA. That said, we expect that the HKMA will assess, among other things, whether the fund makes private equity investments, and whether the local employment and spending requirement are met.

What types of recipients of carried interest may benefit from the proposed carried interest tax concession in Hong Kong?

In view of the Hong Kong government's policy objective to attract more private equity funds to operate in Hong Kong, the Proposal requires that only the following recipients of carried interest can be eligible for the concessionary tax treatment:

- a) corporations licensed with the Securities and Futures Commission ("**SFC**") or authorized financial institutions registered under the Securities and Futures Ordinance for carrying on a business in any regulated activities;
- b) any other person or entity providing investment management services *in Hong Kong* to a qualified investment fund (i.e., a fund with at least five investors and meeting certain requirements over capital commitments and distributions of net proceeds); and
- c) employees of any of the foregoing in (a) and (b) and their associated corporations or partnerships that carry on business *in Hong Kong*.

In addition to the foregoing requirements on the carried interest recipients, the Proposal also requires that:

- Investment management services, from which the carried interest is derived, must be provided in Hong Kong.
- Carried interest recipients in (a) and (b), above, must have adequate number of qualified full-time employees and operating expenditures incurred in Hong Kong for the relevant years of assessment, including, for each year of assessment concerned:
 - on average at least two full-time employees in Hong Kong carrying out investment management services; and
 - at least HK\$2 million of operating expenditure incurred in Hong Kong for providing such investment management services.

What is considered eligible carried interest?

The Proposal defines “eligible carried interest” as a sum received by or accrued to a person by way of profit-related return subject to a hurdle rate i.e., the preferred rate of return on investments in the fund which must be met before carried interest can be received by fund managers.

Carried interest vs. management fees and other remunerations

In order to limit the scope of the tax concession treatment to carried interest only, the Proposal seeks to distinguish carried interest from management fees and other form of remunerations that private equity funds managers typically receive, by characterizing carried interest as returns arising from, and varying by reference to, profits on investments made by a fund (as opposed to sums that in substance would certainly arise), while the same profits giving rise to carried interest also determine the return to external investors of the fund.

The Proposal specifically states that if there is no significant risk that at least a certain amount of remuneration would not be received by, or accrued to, the recipients, then such amount will not be regarded as “carried interest” for purposes of the tax concession. Moreover, the Proposal emphasizes that the forthcoming amendment bill will specify that management fee (even if disguised as eligible carried interest) received by qualifying carried interest recipients would not be eligible for the tax concession.

Venture capital funds

It is also noteworthy that the definition in the Proposal refers to the hurdle rate. While nowadays the distribution waterfall for most, if not all, private equity funds include a hurdle rate, it is not uncommon to see venture capital funds that do not require any hurdle rate in the waterfall. Under the Proposal, managers of such venture capital funds may not be eligible for the carried interest tax concession.

What next?

According to the Proposal, the Hong Kong government is formulating the legislative proposals to implement the proposed tax concession, and its target is to introduce the amendment bill into the Legislative Council in late January 2021. Subject to the passage of the amendment bill by the Legislative Council, 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.

How should you take advantage of the proposed tax concession treatment?

The introduction of the 0% tax concession rate on carried interest significantly substantiates the previous launch of the Hong Kong Limited Partnership Fund regime on 31 August 2020 and the unified fund tax exemption regime on 1 April 2019.

A fund manager that is planning to form a new investment fund and would like to enjoy all these benefits should seriously consider structuring its next fund as a Hong Kong Limited Partnership Fund domiciled in Hong Kong and appointing a Hong Kong SFC-licensed investment manager to manage the fund.

If the fund is domiciled outside Hong Kong or the person providing investment management services to the fund is outside Hong Kong, the tax concession treatment may still apply, but there are additional requirements which should be reviewed on a case-by-case basis with professional advisors.

How can Fangda Partners help?

Members of the investment funds team at Fangda Partners have been closely involved in the development of the Hong Kong Limited Partnership Fund regime, and have been actively participating in the industry discussions and consultations on the legal and tax reforms to help promote the development of private equity funds industry in Hong Kong. Since the commencement of the Hong Kong Limited Partnership Fund regime, we have helped clients successfully establish and close on investment funds as limited partnership fund under this new framework.

Please feel free to reach out to us if you have any questions regarding Hong Kong Limited Partnership Fund regime or the proposed tax concession treatment on carried interest.

Beijing

27/F, North Tower
Beijing Kerry Centre
1 Guanghua Road
Chaoyang District
Beijing 100020, China

Tel: +86 10 5769 5600
Fax: +86 10 5769 5788

Guangzhou

17/F, International Finance
Place, 8 Huaxia Road,
Zhujiang New Town
Guangzhou 510623, China

Tel: +86 20 3225 3888
Fax: +86 20 3225 3899

Hong Kong

26/F, One Exchange Square
8 Connaught Place, Central
Hong Kong

Tel: +852 3976 8888
Fax: +852 2110 4285

Shanghai

24/F, HKRI Centre Two,
HKRI Taikoo Hui
288 Shi Men Yi Road
Shanghai 200041, China

Tel: +86 21 2208 1166
Fax: +86 21 5298 5599

Shenzhen

17/F, Tower One, Kerry Plaza
1 Zhong Xin Si Road
Futian District
Shenzhen 518048, China

Tel: +86 755 8159 3999
Fax: +86 755 8159 3900