Hong Kong's Carried Interest Tax Concession – Zero % Tax!

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Following the enactment last year of the Limited Partnership Fund Ordinance, which has seen strong take up in its first eight months of operation, the new tax concession on carried interest earned from the activities of private equity funds which was proposed by the Hong Kong Government in 2020, has now been introduced. The Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Ordinance 2021 ("**Ordinance**") was enacted into law on 7 May, 2021, by way of amendment to the Inland Revenue Ordinance ("**IRO**"). Under this new concession, eligible carried interest received or accrued on or after from 1 April, 2020 will be subject to zero percent profits tax. Individuals who have received carried interest or to whom any such sum has accrued, will also be eligible for a 100% deduction for those sums against their assessable income.

Background

In formulating policy for the development and growth of the local fund management industry, the Hong Kong Government has worked closely with local professional services firms and industry organisations with the objective of making Hong Kong a more attractive environment for fund managers. As well as enacting legislation to make new fund vehicles[1] available which are familiar to international sponsors and investors, a key focus has been on the development of a tax friendly regime, particularly for private equity funds, for whom tax is a key factor when looking at where to locate the domicile and operations of each of the fund and the manager. In 2019, the Hong Kong Government took the final step in the creation of what has come to be called the "Unified Funds Exemption" regime ("**UFE**"), when the scope of the existing tax exemption for offshore funds was extended to onshore based funds. As from 1 April, 2019, the tax legislation adopted a level playing field in its treatment of both onshore and offshore funds. Recognising that carried interest forms a major component of compensation for private equity professionals, the follow on step of introducing a tax concession for carried interest is intended to up Hong Kong's game in the competition with other jurisdictions, most notably Singapore, for the business of asset managers. The goal of the Hong Kong Government is to create the conditions to attract more managers onshore which it is expected will in turn bring its own tangible economic benefits to Hong Kong.

Hong Kong-centric approach

Before laying out the principal gating conditions for eligibility for the new tax concession, it should be noted that the key requirement running through the concession is that it will apply only to carried interest which arises in or is derived from Hong Kong in return for investment management services which are performed in Hong Kong. This reflects the policy objective of the Ordinance which is to incentivise private equity managers to set up operations in the Territory, and the conditions to eligibility underscore this point. As a key example, a substantial activities test[2], outlined below, requires that a minimum threshold of operations must have been established and maintained in Hong Kong as a prerequisite to eligibility.

Another key component to note is that for the tax concession to be available at the fund level, the fund itself must first qualify for tax exemption under the UFE. Given that eligibility for the tax concession will only be available if carried interest is paid by a fund that has been certified (“**certified investment fund**”) by the Hong Kong Monetary Authority (“**HKMA**”) to be in compliance with to be published criteria for certification, funds seeking this status, as well as their management structures, should expect to be subject to much closer scrutiny from the Inland Revenue Department (“**IRD**”).

Current tax treatment of carried interest

Hong Kong has a territorial system of taxation under which it will assess profits tax on a person carrying on a business in Hong Kong in respect of profits arising in or derived from Hong Kong from that business. Carried interest payable from profits arising in or derived from Hong Kong would be subject to the normal principles for the assessment of profits tax to be assessed at the marginal rate. If there is both an onshore adviser and offshore manager/general partner, the IRD would seek to determine whether the adviser has been adequately remunerated for its services relative to those of the offshore entity. If it considers the offshore compensation to be disproportionate, then it is likely to attribute a proportion of the income received offshore to the onshore manager applying local general anti-avoidance rules.

Additionally, carried interest paid to an employee which arises in or is derived from Hong Kong from that employment would be subject to salaries tax. This comes down to a factual question of where the employment, the source of income, was located, which will often be self-evident from the surrounding circumstances. The new tax concession is designed also to extend to any salaries tax that might otherwise be assessed on an employee in receipt of a carried interest payment which is eligible for the concession.

Eligible carried interest

The term “eligible carried interest” refers to 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 in Hong Kong. Those services must have been provided to a “certified investment fund”.

Broadly, a sum is received or accrued by way of “profit-related return” if (a) it is made after the payment of a return on investments in the fund once the preferred rate of return for investors in the fund (i.e. “hurdle rate”) has been met, (b) there are profits for a period on the investments, or from a disposal of an investment, (c) it is variable by reference to those profits, and (d) the returns to the fund’s external investors are also determined by reference to those profits. However, where any such sums are so received by a person, and there was no significant risk that at least part of those sums would not be received by, or accrued to, the person, that part of sums will not be treated as eligible carried interest.[3]

Carried interest tax concession - conditions

Must be paid by a qualifying payer

The carried interest must be paid by a certified investment fund i.e. a qualifying payer (see below). “Fund” has the meaning given to in the IRO[4], which largely mirrors the definition of a “collective investment scheme” set out in the Securities and Futures Ordinance (“**SFO**”)[5]. The certification of the fund to be made by the HKMA will be carried out under a separate administrative scheme[6], which will require the fund to apply to the HKMA, supported by such documents and information as may be required by the HKMA to make its assessment on the applicant. The fund would then undergo a validation process to determine if it qualifies as a certified investment fund. A non-resident fund would apply for this certification through its locally appointed authorised representative.

Must be derived from qualifying PE transactions

Only carried interest representing profits earned from “qualifying transactions” in PE type investments will be eligible for the tax concession. These must be profits earned from transactions that principally include (i) shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a private company[7] or an investee private company[8], or (ii) shares of, or comparable interests in, a special purpose entity (“**SPE**”)[9] or an interposed SPE[10] that holds (whether directly or indirectly) and administers only one or more investee private companies (“**qualifying PE transactions**”). It should be noted that the scope of these transactions does not include all asset classes, and notably fund of fund type investments is absent from the list.[11]

As already highlighted, profits earned from any such transaction by a certified investment fund or an SPE must also be exempt from profits tax under the UFE. This last requirement would mean establishing first that the profits were exempt at the fund level, as a gating matter to the grant of the tax concession for any carried interest paid or received on those profits.

Must be received by a qualifying recipient

The recipient of the carried interest must be any of the following persons for a year of assessment, during the basis period for the year of assessment, (the persons in paragraphs (a) and (b), the “**qualifying person**”):

(a) a corporation licensed to carry on, or an authorised financial institution registered for carrying on, a business in any regulated activity under the regime for securities intermediaries under the SFO;

(b) a person not falling into paragraph (a), who carries out investment management services, or arranges such services to be carried out, in Hong Kong, for a certified investment fund that is a “qualified investment fund”;[12] or

(c) an individual who has earned assessable income from employment with a person in paragraph (a) or (b), by providing investment management services in Hong Kong for, or on behalf of, that person for a certified investment fund.

Provision of investment management services

The carried interest must be derived from the provision of investment management services in Hong Kong to a certified investment fund. “Investment management services” is defined to include in relation to a certified investment fund, (a) seeking funds from external investors or potential external investors, (b) researching and advising on potential investments, (c) acquiring, managing or disposing of property or investments and (d) acting for the fund with a view to assisting an entity in which the fund has made an investment to raise funds.

Substantial activities requirements

Threshold and ongoing requirements will apply to ensure that beneficiaries of the tax concession will be undertaking core income generating activities in Hong Kong in the applicable assessment year. The condition requires that during the whole of the period beginning on the day on which a person begins to carry out investment management services directly or indirectly for a certified investment fund and ending on the day on which eligible carried interest is received by, or accrued to, the person:

- the average number of full-time employees in Hong Kong who carry out the investment management services and have the qualifications necessary for doing so during the basis period for each year of assessment falling within the applicable period is adequate in the opinion of the IRD, and in any event, 2 or more; and
- the total amount of operating expenditure incurred in Hong Kong for the provision of the investment management services during the basis period for each year of assessment falling within the period is adequate in the opinion of the IRD, and in any event, HK$2,000,000[13] or more.

Carried interest earned by individuals

As mentioned above, the scope of the tax concession also extends to carried interest received by an individual assessable to salaries tax. An individual who is a “qualifying employee” will be entitled to a 100% deduction of the amount of the eligible carried interest from the employee’s assessable income accrued from the employment for the year of assessment. To be a “qualifying employee”, the employee must be (a) employed by (i) a qualifying person (see above), or (ii) the associated corporation, or the associated partnership, of a qualifying person who is a corporation or a partnership, if the associated corporation or the associated partnership carries on a business in Hong Kong, and (b) carrying out the duties of the employment by providing investment management services in Hong Kong for, or on behalf of, the qualifying person.

The use of “associated corporation” and “associated partnership”, which incorporate a typical “control” (i.e. group) concept to define the relationship with the qualifying person, is helpful in that commonly the private equity professionals within the group will be employed by a separate group employing company which will provide the services of the professionals to the other parts of the group. These terms have not, however, been expressly incorporated into the separate substantial activities provisions that require a minimum number of employees, and given this, it remains to be seen how the IRD will apply these provisions where employees are employed by a group employing entity.

HKMA validation

As mentioned above, a key component of the tax concession is that the fund from which the carried interest is ultimately earned, must be certified by the HKMA. This requirement that the fund be a certified investment fund, runs through the terms of the concession, and once certified, a fund for which claims have been made, will be subject to an ongoing monitoring and validation process. It is seen as a positive step that the task of certification has been put in the hands of what is effectively Hong Kong's central bank, which has indicated that it wants to make the certification criteria as user friendly as possible. The Ordinance also provides that once the IRD has received a claim, it may seek advice from the HKMA on any matter it considers appropriate in relation to the claim.

On this subject, whilst not contained in the Ordinance, it will also be necessary in a particular year of assessment where there is a distribution of eligible carried interest, that the fund engage an external auditor to verify that the substantial activities requirements referred to above have been met in the particular years of assessment, and that the distribution fulfils the conditions under the tax concession regime.[14] This report should then be kept at the fund's local office, or with the local authorised representative of a non-resident fund, for inspection if needed.[15]

Broadening the investment scope for SPEs under the UFE

A separate and welcome amendment contained in the Ordinance is the broadening of the scope of investment transactions permitted at the SPE[16] level to align it with that at the fund level, for the purposes of the eligibility of profits earned from those transactions for exemption from profits tax under the UFE (referred to as "qualifying transactions") [17]. The in-scope transactions permitted for a private equity fund eligible to qualify for profits for exemption under the UFE are broad and include for example, listed securities, fund interests, foreign exchange contracts etc. By comparison, currently, an SPE is only allowed to hold and administer investee private companies, but not other financial assets. The Ordinance allows an SPE (a) to hold and administer assets in the same classes as a private equity fund, and (b) to carry out transactions in such assets on behalf of the fund. However, this expansion of the categories of transactions has not been extended to the carried interest tax concession, which is confined to profits earned from "qualifying PE transactions" only.

Conclusion

The overall thrust of the new tax concession when combined with the UFE is to create the right conditions to encourage increased critical mass in the onshore private equity funds industry and to develop Hong Kong as a "premier PE fund hub"[18]. Given the popularity of the new limited partnership fund regime, it seems highly likely that the creation of added tax incentives for private equity funds and their onshore managers will only serve to enhance that position. The larger question which looms, and which can only be answered in the longer term, will be whether or to what extent the larger offshore PE firms, in particular the global firms, who currently do not have onshore fund and asset management operations in Hong Kong, might be sufficiently attracted to bring some of those operations onshore so as to benefit from these incentives?

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[1] As well as the Limited Partnership Fund Ordinance which came into effect in August, 2020 (see our client alert "The Arrival of Hong Kong's Limited Partnership Fund Regime"), legislation creating the regime for open-ended fund companies (OFC) came into effect on 30 July 2018.

[2] The test is intended to ensure compliance with the OECD's latest international taxation standards, including its anti-Base Erosion and Profit Shifting 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 (LC Paper No. CB(1)780/20-21).

[3] This borrows from the language of the UK Income Tax Act 2007 (Section 809EZC(3)(b) (*Meaning of "carried interest" in section 809EZB)*) which is directed at sums disguised as carried interest and which are in substance virtually certain to arise.

[4] See Section 20AM of the IRO.

[5] See Part 1 of Schedule 1 of the SFO.

[6] The HKMA has prepared a draft set of the guidelines, including forms, which are in circulation for consultation but as of the time of writing, the final version has yet to be published.

[7] “Private company” means a company (whether incorporated in or outside Hong Kong) that is not allowed to issue any invitations to the public to subscribe for any shares or debentures of the company (see Section 20AO of the IRO).

[8] In relation to a fund, this refers to a private company held by an SPE or an interposed SPE as shareholder on behalf of the fund (see Section 20AO of the IRO).

[9] A corporation, partnership or trustee or any other entity that is wholly or partially owned by a fund (see Section 20AO of the IRO).

[10] Referring to any corporation, partnership or trustee or other entity that is interposed between the SPE and the portfolio company (see Section 20AO of the IRO).

[11] The scope should however include PE exits on an IPO, taking into account any lock up on the securities held by the fund (see LC Paper No. CB(1)821/20-21 and IRD Departmental Interpretation and Practice Note No. 61 (Profits Tax - Profits Tax Exemption For Funds)).

[12] See Section 20AN of the IRO. This refers to a fund possessing certain required characteristics as one of the conditions to qualifying for tax exemption under the UFE.

[13] Equivalent to approximately US$250,000.

[14] See the Legislative Council Brief on the Bill (File Ref: ASST/3/1/8/1C).

[15] See paragraph 16 of Legislative Council Brief on the Bill (File Ref: ASST/3/1/8/1C).

[16] See footnote 9.

[17] See Schedule 16C of the IRO.

[18] See footnote 14.